Big Crops Get Bigger

There is a common saying in the corn and soybean futures market that “big crops get bigger,” which means that the USDA production forecasts tend to increase during the harvest months into the final report in January. The October World Agricultural Supply and Demand Estimates (WASDE) confirms this saying by projecting that the 2014 corn crop is going to shatter yield records and production records by a large margin. The report has pegged the U.S. average corn yield at 174.2 bushels per acre which is 9.5 bushels/acre greater than the previous record yield set in 2009. Still, private sector analysts were disappointed in USDA’s projections as the pre-report estimates, and anecdotal harvest information from the mid-South and Midwest, suggested that an even larger yield projection should have been in the October USDA report. There is a belief held by the private sector analysts that USDA is being cautious in their yield projection methodology, and further increases could come in the November report and the final projection in January. Some are projecting that the U.S. average yield could increase an additional 1 to 2 bushels/acre by the January report, which could add an additional 166 million bushels to production.

Farmers are projected to harvest 83.1 million corn acres this year, which is down 4.6 million acres from last year. The near perfect weather that most of the corn production regions enjoyed is allowing farmers and seed companies to fully understand the yield potential for corn. Even with fewer harvested acres, the U.S. corn crop is pegged to come in at 14.475 billion bushels, or about 550 million more bushels than the 2013 crop. When you include the larger beginning-stocks, the total corn supply for 2014-15 is 9.54 million bushels larger than the previous year.

Unfortunately, demand isn’t expected to keep pace with the swelling supply as total corn use is projected to increase by 109 million bushels over the previous year’s use. Feed and residual is projected to increase slightly as the livestock and poultry industries are expecting healthy profits due to lower feed costs. Industrial use for corn, which has been the growth area for demand, is projected to increase slightly from the previous year. However, the growth isn’t projected to come from ethanol use as that market is mature and hitting the blending wall. Corn exports are projected to decline from the 2013-14 marketing-year due to increased competition from South America and the Black Sea region.

Corn ending-stocks are projected to continue to build to over 2.08 billion bushels, which is an increase of 845 million bushels from the 2013-14 marketing-year. The larger corn stocks have eliminated the risk premium in price that has existed since 2010. The U.S. average farm price for 2014-15 is projected to be $3.40 per bushel, which is down sharply from the $4.46 per bushel price in 2013-14.

The October report also confirmed an even larger soybean crop than was projected in the September report. The soybean yield of 47.1 bushels/acre would be a record as is the total production of 3.93 billion bushels. The 2014 soybean crop is 569 million bushels larger than the 2013 crop. Given reduced imports and lower beginning stocks, the 2014-15 soybean supply is projected to increase by 464 million bushels.

Like corn, projected use will not keep pace with the surge in production. The October report didn’t adjust any of the use projections from September. Crushing and exports are projected to increase slightly from the previous marketing-year. Exports will face stiff competition from South America in the second-half of the marketing-year when the 2015 South American soybean crop is harvested and hits the market. Total soybean use is projected to increase 105 million bushels from the 2013-14 marketing-year.

Soybean stocks are projected to increase by 358 million bushels this marketing-year. The soybean market has been flirting with very tight stocks since the 2008-09 marketing-year, which has supported high prices. That risk premium is eroding as the stocks-use ratio for soybeans is projected to increase from 2.6% for 2013-14 to 12.6% for the 2014-15 marketing-year. As the stocks swell, the U.S. average farm price is projected to decline from $13/bushel to $10/bushel.
Late maturing crops and late season rains have slowed the corn harvest across the country. As of October 26, 46% of the US corn crop has been harvested which is about 19% behind the 5-year average. Soybean harvest is progressing slightly behind average as about 70% of the US soybean crop is harvested compared to a 5-year average of 76%. The Kentucky corn harvest is unfolding at the 5-year average pace, but soybean harvest is later than average. As of October 26, about 40% of the state’s soybeans have been harvested compared to a 5-year average of 58%.

This slower harvest has potentially helped the corn and soybean markets find a short-term bottom. The December corn and November soybeans futures closed at $3.21 and $9.13, respectively, on September 30. The futures closed at $3.64 and $10.08, respectively on October 26. Perhaps the corn and soybean futures markets have come to psychological terms with the record crops, and are working out of their over-sold positions.

~ Todd Davis

Understanding the Basis of Assets

According to the Internal Revenue Service (IRS), basis is generally the amount of your capital investment in a property for tax purposes. Machinery, equipment, purchased breeding animals, livestock facilities, barns, fencing, greenhouses, and storage structures are common examples of depreciable property found on farms. Farmland is not depreciable since it does not have a definite life, nor is a home because it is personal property. Let’s look at determining basis and tax consequences based on the different types of assets a farming operation might have.

The first category of assets to evaluate is the depreciable items. The adjusted basis of these items is the amount originally invested in the property less any allowable depreciation. For example, let’s say you buy a tractor (no trade involved) for $150,000 during the 2005 tax year. Then in 2014, you sell the tractor for $75,000. What would your gain be in the tractor? Tractors have a depreciable life of seven years, so it would be completely depreciated out by tax year 2011. Your adjusted basis in the tractor would be $0. Gain is calculated by subtracting your adjusted basis ($0) from your sale price ($75,000), for a $75,000 gain. This type of gain is called ‘recapture’ and is taxed at your ordinary income tax rates. In other words, you are recapturing the depreciation you used on prior years’ tax returns. Let’s say you sold the same tractor for $155,000 in 2014. Your gain would be $155,000 (sale price less adjusted basis), however $150,000 would be ‘recapture’ taxed at your ordinary income tax rates while $5,000 would be considered capital gain taxed at capital gain rates.

Now, let’s look at farmland. For example, let’s say you purchased 40 acres of land for $160,000. The property had no buildings, fencing, tile, or any other depreciable items on it, then your adjusted basis in the ground would be $160,000. If you later sold the ground for $200,000, then you would pay capital gains on your ‘gain’ of $40,000. Keep in mind that you have to ‘hold’ your property for at least one year for it to be ‘capital’ gain rather than ‘ordinary’ gain. In another example, let’s say you paid $250,000 for a 50 acre property that was tiled when you purchased it and also had three barns on it. You and your tax preparer allocate $50,000 of the purchase cost to the tile and barns. Those are depreciable items and will depreciate over their useful life. Your adjusted basis in the land would then be $200,000 ($250,000-50,000).

If an asset is gifted or inherited, then establishing the basis could be more complicated. The adjusted basis of gifted property carries over to the taxpayer that it was gifted to. An easy (and common) example of this would be a parent gifting land to their child. Let’s say the parent purchased 50 acres in 1990 for $45,000. It was bare ground with no depreciable items, so the parent’s adjusted basis in the property is $45,000. In 2012 the parent gifted the property to their child. Even though at the time of the gift (2012) the fair market value of the property was $225,000 the child’s adjusted basis is only $45,000. If the child decides to sell the property for $225,000 they will pay capital gains on $180,000 ($225,000-45,000). The holding period for gifted property includes the time the donor held the property.

Inheriting an asset is much different than being gifted an asset. Rather than getting the adjusted basis of the person you are receiving it from, you actually receive what is called a ‘stepped up’ basis. What that means is that your adjusted basis in the property is the fair market value on the date of death of the person from whom you receive it. Again, let’s look at the same
land example as above between a parent and child. Parent buys the land in 1990 for $45,000. Parent passes away in 2012. At the time of the parent’s death, the land had a fair market value of $225,000. The child inherits the property through the parent’s estate. The adjusted basis for the child is $225,000. The child decides to sell the property for $225,000. The child will not have to pay any capital gains on the sale since their gain is $0 ($225,000-225,000). Inherited property is considered held more than one year regardless of how long it is actually held and will be taxed at capital gain rates.

It is definitely important to understand adjusted basis and gains when selling property so you don’t have any surprises at tax time. It is equally important to understand the difference in gifting versus inheriting property if you are estate planning. Talk to your tax advisor if you plan on doing either of these things.

~ Suzy Martin

Does Winter Backgrounding Present an Opportunity this Year?

Cow-calf operators are currently enjoying the strongest fall calf market on record. While calf prices typically decrease from summer to fall, that has not been the case this year. The combination of increasing spring 2015 live cattle futures and continual declines in corn prices have added fuel to a feeder cattle market that was already on fire. While this strong calf market is music to the ears of cow-calf operators, it represents cost challenges for backgrounders interested in placing calves in winter programs for sale in the spring. In fact, some may be hesitant to place calves in this current market. This article examines potential returns to backgrounding programs this winter.

At the time of this writing (October 20, 2014), spring 2015 feeder cattle futures were trading in the upper $220’s. As winter backgrounders consider purchasing calves this fall, these spring futures prices provide market expectations for feeder cattle sale prices. A futures price in the upper 220’s suggests a likely Kentucky price for 850 lb steers in the low $210’s in the spring. As an example, with spring feeder cattle futures at $227, and a -$16 basis, an 850# feeder steer in Kentucky would be expected to bring around $1,794 (850@ $2.11 per lb) in the spring of 2015. Of course, actual basis is heavily impacted by local market conditions, lot size, cattle quality, location, and numerous other factors.

Basis for 850 steers next spring is likely to be impacted by larger price slides as futures prices are largely indicative of 750 lb feeder steers. This basis will likely change compared to the last few years for two reasons. First, the overall market is much higher, which tends to widen price slides. Second, with corn much cheaper as a result of the large 2014 crop, price slides are also likely to be larger due to the lowered winter feed costs. The -$16 basis discussed previously is based on an expected basis for 750 lbs steers around $6 under the board and an additional $10 for price slide from 750 to 850 lbs. Regardless, producers considering winter backgrounding should make some estimate of spring sale price as they start to consider what can be paid for calves this fall. An excellent reference for predicting sale prices based on futures is AEC 2013-09, “Using the Futures Market to Predict Prices and Calculate Breakevens for Feeder Cattle” which can be found at the UK Agricultural Economics website.

The Kentucky Livestock and Grain Market Report for the week ending on October 17th reported a state average price for 500-550 lb steers of $247, and a state average price for 550-600 lb steers of $242. If this range is used as a starting point, one might expect to place 550 lb steer calves for around $245 per cwt, or something close to $1,350 per head. Larger groups of high quality calves would certainly sell for more than this, so individuals are encouraged to apply this process to the type of calves they typically buy. However, based on the calf prices described here and a -$16 basis estimate for 850 lb feeder steers this spring, the current market appears to be offering more than a $400 gross margin for 550 lb calves placed in winter programs now to be sold in the spring as heavy feeders.

From here, one must make some cost estimates on wintering those calves and selling them in the spring. While we provide an estimate for a specific winter program, costs will vary greatly based on local conditions and the specific backgrounding program. Feed is the major cost and producers should consider all potential feeding options including commodity feeds, corn, and corn silage. For this scenario, we will consider a single program where calves are fed 1.5% of their body weight per day of a 50 / 50 corn gluten / soy hull mix, and another 1.5% of their body weight per day of grass hay. While performance will vary, we will assume a rate of gain of approximately 2.3 lbs per day, which would put on 300 lbs in approximately 130 days.

In terms of costs, we will value the corn gluten / soyhulls at $200 per ton and value the grass hay at $80 per ton. Health costs are assumed to be $25 per head, commission is set a $51 per head, and transportation is set at $15 per head. An interest charge of 4% is included and death loss is assumed to be 2%. These costs will vary by location and operation, so readers are encouraged to come up with their own estimates.

Several of these cost estimates are worth careful consideration. For example, we have assumed commission of roughly $6 per head plus 2.5% of value. However, many yards offer considerable commission savings on larger groups, as do other market methods. Vet and medicine costs are also important. We have assumed $25 per head, which is likely sufficient to
include mass medication of all calves. However, this is a decision that the individual producer should make. Finally, we would point out that our analysis largely assumes that calves are being purchased. If this was done for a cow-calf operator who was considering backgrounding his or her own calves, several costs would change. First, it is likely that one might lower vet, medicine, and deathloss for raised calves. Secondly, transportation and commission would be paid on the calves if they were sold, so the relevant costs become the difference in commission and transportation paid on the heavy feeder versus the calves, rather than the total costs. With these caveats in mind, the following table shows expected returns to the program described above.

Table 1: Winter Backgrounding Budget Estimate

<table>
<thead>
<tr>
<th>Sales</th>
<th># units</th>
<th>unit</th>
<th>price / unit</th>
<th>total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Feeder</td>
<td>849</td>
<td>lbs</td>
<td>$2.11</td>
<td>$1,791</td>
</tr>
<tr>
<td>Expenses</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Stocker Calf</td>
<td>550</td>
<td>lbs</td>
<td>$2.45</td>
<td>$1,348</td>
</tr>
<tr>
<td>Hay</td>
<td>1365</td>
<td>lbs</td>
<td>$0.04</td>
<td>$55</td>
</tr>
<tr>
<td>Hulks/ Gluten</td>
<td>1,365</td>
<td>lbs</td>
<td>$0.10</td>
<td>$137</td>
</tr>
<tr>
<td>Mineral</td>
<td>0.25</td>
<td>lbs / day</td>
<td>$0.40</td>
<td>$13</td>
</tr>
<tr>
<td>Vet / Med</td>
<td>1 head</td>
<td></td>
<td>$25.00</td>
<td>$25</td>
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<tr>
<td>Commission</td>
<td>1 head</td>
<td></td>
<td>$51.00</td>
<td>$51</td>
</tr>
<tr>
<td>Hauling</td>
<td>1 head</td>
<td></td>
<td>$15.00</td>
<td>$15</td>
</tr>
<tr>
<td>Other</td>
<td>1 head</td>
<td></td>
<td>$10.00</td>
<td>$10</td>
</tr>
<tr>
<td>Interest</td>
<td>4%</td>
<td>rate</td>
<td>$22</td>
<td></td>
</tr>
<tr>
<td>Death loss</td>
<td>2%</td>
<td></td>
<td>$28</td>
<td></td>
</tr>
<tr>
<td><strong>Total Expenses</strong></td>
<td></td>
<td></td>
<td><strong>$1,703</strong></td>
<td></td>
</tr>
</tbody>
</table>

| Return to Land, Capital and Mgt | $89 |

As can be seen in Table 1, projected returns are $89 per head this winter, based on the assumptions discussed previously. Producers are strongly encouraged to modify these assumptions for their individual programs to better reflect calf values and expected spring basis, as well as cost estimates and feed prices for their area. It is also worth noting that labor, depreciation, and interest on owned capital are also not included in the budget, so the return shown is a return to land, capital, and management. Producers should ask themselves if that return adequately compensates them for their time, capital investment, management, and risk.

The two key assumptions made in Table 1 include the cost of the calves being placed and the expected sale value in the spring. Changes in calf placement costs will greatly impact winter backgrounding returns. For every $5 per cwt decrease in the purchase price of the calves, the return to land, capital, and management increases by $27.50 per head. The second assumption, the sale price for the feeder calf, won’t be known with certainty until spring. Note that the assumed spring sale price in the analysis is $211 per cwt and the projected return is $89 per head. A $10 per cwt decrease in sale price would result in actual returns falling to $0.

Other assumptions can also have significant impacts on expected profitability. For example, a decrease in commission from $51 to $13, if selling in large lots, would bring the expected profit up to $127. The commission on small lot sizes has increased dramatically in the last two years while the price for large lot sizes has remained the same, creating a major cost disadvantage for small operators trying to compete in this high priced market. A $25/ton decrease in price in corn-gluten/soyhulls would increase expected profit by $17 and vice versa.

Given the assumptions of the analysis in Table 1, returns are decent. As always, winter backgrounders are encouraged to explore opportunities to manage downside price risk through contracting, futures and options, LRP insurance, and other strategies. While it does appear that the market is providing opportunities for winter backgrounding, it is also clear that price risk is high and producers will have a great deal of money invested in these programs. Therefore, some additional effort should be applied to considering strategies to manage that downside risk. Winter backgrounders should carefully calculate their breakeven purchase prices for calves and be opportunistic as they approach this fall.

As Greg Halich & Kenny Burdine

KyFarmStart’s Second Annual Beginning Farmer Conference Nov. 14 - 15, 2014

Beginning and early career farmers have an opportunity to ramp up their business and technical skills, network with other farmers and connect with key resource providers at the second annual Beginning Farmer Conference; which will be held November 14-15 at the Leestown Rd. campus of the Bluegrass Community and Technical College (BCTC) in Lexington. Last year, about 150 farmers participated in a one-day program. They overwhelmingly asked for a longer program, so this year the annual event will take place over both a Friday and Saturday.

Participants will choose between one of three sessions for Friday, all starting with farm tours in the morning before returning to the conference site for lunch and further training. One option is artisan cheese making, starting with a visit to Bluegrass Chevre. The second track will help farmers learn about running a CSA, and they’ll get to see how Elmwood Stock Farm does it. Folks interested in pasture-based meat production will start with a visit to the Clark Farm. After returning to BCTC, participants will have lunch followed by classroom sessions on their chosen topics. The day will end with a local foods/networking reception at the University of Kentucky. The Friday program includes a large array of panels mostly made up of successful farmers, but also including local experts. Topics range
from financing to land access and from branding to managing high tunnels.

This workshop is part of the KyFarm Start program, an effort of the University of Kentucky College of Ag, Food and Environment and Community Farm Alliance to help beginning farmers achieve success. KyFarm Start is funded by the USDA NIFA Beginning Farmer and Rancher Development program and other sponsors. For more information and to register, please go to the Community Farm Alliance website (www.communityfarmalliance.org), or contact Sarah Lovett (sarah.lovett@uky.edu) or Carolyn Gahn (carolyn@cfaky.org).

~ Lee Meyer