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FOREWORD

Many questions are being raised regarding Vertical Integration in Ohio. It is difficult to anticipate all questions that may arise. This discussion guide brings together facts in four major areas:

1. What is Vertical Integration?
2. Why the Current Interest in Vertical Integration?
3. What Should a Farmer Consider in Becoming Involved in Vertical Integration?
4. Current Developments in Vertical Integration in Ohio.
   a. General Livestock
   b. Poultry
   c. Dairy
   d. Fruits and Vegetables

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WHAT IS VERTICAL INTEGRATION

Integration in business refers to combining small units into one larger unit under one management. There are two types of integration: Horizontal and Vertical.

Horizontal Integration is the combination of businesses that are alike into one larger business. In farming this would be the case when two farms are combined under one management.

Vertical Integration is the combination or centralizing of two or more of the various stages of production, processing and marketing of a product under one management.

Vertical integration can be done in three ways in farming: 1) by contract with the farm-operator, 2) by extending the farm-operator's ownership and control over processing and distribution, 3) by a processor or distributor purchasing and/or renting land, hiring labor and providing equipment or livestock for production.

A farm enterprise may be partially integrated. For example, a processor of broilers may contract with a farmer to house and feed the broilers. The processor may have no contract for retailing the finished product. The broiler enterprise would be completely integrated if the processor owned and controlled retail outlets for the birds raised by farmers under contract to the processor.

The integrator in vertical integration is the firm or agency where the management is centralized. The integrator contracts with others or assumes some degree of control over the other businesses. Any firm can be the integrator including the farmer. Some people think that farmers should give much more thought to how they can do more of the integrating through their own associations and organizations.

Vertical integration centralizes management and coordinates and unifies management. Instead of a number of separate farmers, processors and other agencies, each making separate and often unrelated decisions as the product passes through their hands, integration coordinates all decisions toward getting a a low cost, uniform quality product to the consumer at the right time.

To some extent vertical integration in agriculture is an extension of specialization. The integrator can specialize in management. This leaves the farmer free to specialize in such ways as (1) reducing the number of enterprises and expanding the others, (2) using more efficient machinery and equipment, (3) using other improvement techniques (perhaps to obtain expert advice) and (4) organize his own work more efficiently.

Today a farmer must have a large business and/or available capital in most cases, if he is to be the integrator. When processing and distribution were simple and when the farmer purchased few supplies, he could easily be the integrator, managing the production, the processing and the marketing of the products himself.

One way for the small farmer to participate as an integrator is to affiliate with other farmers or with processing and marketing firms so that specialists in management and technology can be employed.

Vertical integration concentrates control, but may not give complete control of all of the product even in a small area. With a large amount of integration the number of buyers and sellers could be reduced. Control resulting from integration could approach monopoly in a small area and society could be affected. Regulations would probably follow when and if integration resulted in monopoly adversely affecting the public.

WHY THE CURRENT INTEREST IN VERTICAL INTEGRATION IN AGRICULTURE

The history of the development of our economy, especially in recent years has been one of change. This includes both farm and non-farm occupations. In an economic system such as ours, there are constant pressures to do things better. Some of these changes have helped to bring about what we now commonly call vertical integration. Some of the more significant changes include:

(1) Processors Want a More Uniform Supply

Many of the forces which have encouraged vertical integration in farming have come from non-farm industry developing more efficient operations. For example, supermarkets get ample supply of choice beef at certain seasons of the year, but relatively light supplies at other times. If cattle feeders were under contract, arrangements could be made for a continuous ample supply of uniform grade of beef to the retailer.

Some processors have a problem of assuring sufficient supply coming from areas adjacent to their plants. Some processors are using the contract method of integration to get their supplies of sugar beets, tomatoes, broilers, etc.

Packing and processing plants frequently are faced with a problem of uneven need for labor. For example, if the packer hires enough labor to process meat when market receipts are heavy, when the market receives little livestock he must either curtail his labor force or else work them less than 40 hours per week. This creates a labor problem for the packer since approximately 50% of his expenses are for labor. A uniform supply of livestock is important to the packer, but farmers are not furnishing this uniform supply.

(2) Consumers Desire More Uniform Quantity and Higher Quality Product

Consumers want a uniform quality and quantity as well. Most housewives have a fixed budget for meat. If prices for meat vary due to changes in supply, housewives may vary the purchases of certain cuts. Retailers like to have uniform quality to develop new business and hold their customers. Integration offers them this opportunity.

A supermarket chain in Ohio advertised on November 17, 1957:

'There is no turkey taste like fresh turkey taste. We raised 40,000 fresh turkeys for Thanksgiving, purchased 40,000 turkey poults and shipped them to farmers in Southern Ohio..... Broad breasted turkey is famous for its greater amounts of white meat and its delicious flavor.'

Then note this part of the advertisement:

'Specially selected poults; fed to our high standards carefully raised by us; cleaned and dressed by us; packed in crushed ice and rushed fresh to you'.

Doesn't this point up an important reason for a retailer to integrate all the way from the producer through the processor to the consumer?

(3) Farm Suppliers Attempt to Maintain and to Increase Sales

Suppliers who sell farmers 'raw materials' (such as feed dealers) have found that by taking a more active role in the production of certain farm commodities they can maintain more uniform sales and in some instances increase sales considerably. For example, a vertical integration contract may specify

a certain kind and amount of feed will be used. Often when one dealer begins to do this in a community other feed dealers follow, a similar procedure. Suppliers have problems in collecting open book accounts. Companies have found that closer supervision as afforded by vertical integration gives the supplier better control over such accounts. Vertical integration often puts the supplier or processor in a better position to help overcome a management difficulty.

(4) Acquiring Farm Finance, A Difficult Problem

Evidences of the increased need for capital on farms are all about us. In the last 3 decades farmers replaced labor with capital faster than at any time in the history of our country. Acquiring capital has always been a major problem in farming. Farmers are attempting to find a more satisfactory way of obtaining it.

Today many farm operations require an investment of over a hundred thousand dollars. Even though farm prices are decreasing land values have risen sharply in the last few years. Along with higher land prices (and undoubtedly helping to cause them) has been the necessity for individual farmers to acquire more acres to maintain an efficient unit. These pressures plus the fact that most farm operations need refinancing at the death of the operator, will continue to make capital accumulation a major problem for many farmers in the future.

Many farmers are under-financed for present-day efficient farming. The investment in land, machinery, livestock and operating capital for a one-man farm is beyond the financing ability of many young men. Therefore, the alternative of shifting some of the financing to an integrator who may furnish the feed or the specified facilities, the baby chicks, the poults, feeder pigs, etc. sounds good to many farmers today.

(5) Changing Labor Picture

Labor costs have increased more rapidly than most other items of investment on farms in recent years. High non-farm wages are causing more pressure to be placed on farm employers. Non-farm users of labor have been able to out-bid farmers for hired labor. Also many farmers see certain so-called 'benefits' of laboring groups such as more security, less individual risk and frequently a higher return per hour of work. Many feel that by becoming involved in an integrated system, they can obtain some or all of these types of benefits.

(6) Farm Prices Down Relative to Cost

Profits from farming are much more difficult to obtain now

than they were in the 1940-52 period. When prices drop and costs remain the same, farmers are pushed into what we commonly call a 'cost-price squeeze'. When future prices are uncertain, and an integrator comes along and offers an outlet and some return (even though it may be low), farmers may reason that risks are lessened and consider an integrated program for their farms.

(7) Better Farm Management Required

Changes occurring in our economy have increased pressures upon management in agricultural production, processing and marketing. Keeping in closer touch with the commodity from producer to consumer is one way of developing better overall management, or 'know how'. Farmers who do not keep informed on the latest advances in agricultural science, farm management and marketing may gain the advantages of this 'know how' through contract farming or integration. The integrator will hire those who are skilled in the technical knowledge to inform all who are under contract with the integrator.

WHAT SHOULD A FARMER CONSIDER in Becoming Involved in Vertical Integration

The decision of whether to become involved in vertical integration requires weighing of your present situation against the agreements offered by the various integrators. Much depends upon the individual farmer's situation as to how advantageous it will be to enter into a contract with an integrating firm.

Some situations where it might be advantageous to become involved in integration are:

1. For the farmer who has the facilities, labor and 'know how' but lacks operating capital.

2. To get started in farming or to expand operations.

3. To transfer some management decisions to experts who may be better qualified to make them.

4. To secure supervision of operation if the operator is inexperienced.

5. To transfer risk from the farmer to the integrator who may furnish a large share of the cash outlay of the operation.

6. To stabilize income under contracts which provide for predetermined prices or rates of payment for the functions performed.

7. To improve efficiency through use of better equipment and other resources.

8. To give the farmer opportunities to market his product to advantage.

Disadvantages to Vertical Integration

1. The farmer may lose some of his independence which he may value highly.

2. The farmer's ownership of business may be reduced. Ownership frequently is high on the scale of values of many people.

3. If a farmer has been a successful operator in the past he can lose his opportunity to use his special knowledge advantageously.

4. The farmer may lose opportunity to take advantage of price rises. If marketing is included in the contract the producer might have to market on a particular day regardless of price.

5. Rapid increase in vertical integration in an enterprise might result in over-expansion which would depress prices until production adjustments were made.

6. Farmers not entering into an integrated program may be squeezed out by stronger competition from those who integrate.

7. In most contracts a farmer obligates himself for a period of time. This may prevent him from taking advantage of new opportunities or alternatives that arise while the contracts are in effect.

8. The contract can be no better than the management, financial structure and integrity of the organization integrating. The farmer must be informed or he takes the risk of poor performance by the integrator.

Evaluating Contracts

Before agreeing to a contract it should be carefully ana-

lyzed to see what decisions each party proposes to handle, the risks each agrees to assume and the items of production such as livestock, feed, equipment, etc. each will furnish. Some questions that the farmer considering entering into an agreement should ask himself are:

1. How will it affect the risk I am carrying?

   The major risks you are now carrying are:

   1. Risk from disease and death loss in case of livestock risk from adverse weather, insects and disease in case of crops.

   2. Risk from price drop in what you sell.

   3. Risk of price rise in what you buy for production.

   4. Risks from changes in technology - obsolescence in equipment, etc.

2. How will it affect my control over the enterprise to be covered by the agreement?

   As an independent operator you are now making the following decisions that may in whole or part be taken over by an integrator:

   When to sell your products. To whom to sell your products. At what weight to sell. How many and what kind of animals or birds to keep, grow or produce. What feed ration to use and how much. Where to get your feed and what brand to feed. What sanitation practices to use. What equipment to use. What type and how much fertilizer to use. What variety of seed and how much to use. What production practices to use.

3. In what ways will the integrators be better able to make the decisions you might turn over to him than you yourself?

Points To Be Considered in a Contract

What precautions should be taken by the farmer once he has decided it may be to his advantage to enter into an agreement?

1. Be sure to obtain a written, signed, legally binding contract for a definite period of time.

2. The procedure for determining compensation of all parties involved should be clearly stated and understood.

3. Be sure the contract clearly expresses the responsibilities of the parties before signing. In a recent study in Delaware, both the farmer and the integrators were questioned regarding their responsibilities for decisions. There was considerable difference of opinion on several points as to who was to make the decisions.

The following are some things that should be clearly covered in the agreement:

Who owns the animals when the agreement involves livestock, or poultry and who owns the crop when a crop is under contract? Who pays for services of specialists, such as the veterinarians? Also, who calls the specialists? If an animal dies from disease, accident, fire, lightening, etc., or if crops are damaged by hail, flood, wind and drought, who stands the loss?

If animals or crops must be hauled to the farm and later to the market, who is responsible for trucking costs? Who furnishes and pays for the feed, bedding, fertilizer, seed and sprays? If supplies must be hauled to the farm who pays the trucking cost? Will you be permitted to feed your own grain, hay, silage or pasture to the animals under agreement and if so, how will you be compensated?

When livestock are involved to whom does the manure belong and who is responsible for its removal? Who is responsible for paying the personal property tax and insurance on the animals or crops on hand January 1? Who is responsible for record keeping and for making the decisions on production practices such as how the crop is to be grown, fertilized, etc.; how the feeding is to be done; the ration to be fed; the disease control and sanitation practices to be followed; the method and time of marketing, etc.?

If either of the parties is to be compensated by the other for some service rendered, the rate and time of payment should be clearly indicated. How will the agreement be extended or cancelled and what, if any, penalties will be assessed in the event of cancellation by either party?

4. Be sure the integrator assumes a share of the risk of the outcome of the enterprise, if the integrator takes on the responsibility for decisions that may have a significant effect on the income. If he assumes no responsibility, then you suffer for his mistakes in judgment.

5. Be sure of the legal soundness of the contract and that it does not contain escape clauses that enable the integrator to cancel the contract, before you invest in plant or equipment that is to be paid out of the proceeds arising during the life of the contract.

6. Be sure of the extent of the assets and the financial stability of the integrator when he agrees to (a) provide some or all of the items of production such as feed, fertilizer, seed, or animals, or to buy the product produced at a specified price. Large sums of money are needed to fulfill agreements to buy in periods of falling prices and to purchase feed, supplies, or animals on a high and rising market.

7. Be sure you know what liabilities you may be required to assume for the failure of one or both parties to the contract to carry out their respective responsibilities.

It is well to keep in mind that an integrator is not taking on responsibilities for pleasure but rather because he believes he will profit financially. He may sincerely believe that he can increase the net returns of the farmers who join with him as well as himself. However, his interest is first with him.

Before signing, be sure you know how and to what extent you will be better off if you enter into an integration agreement than if you continue as an independent farmer.

CURRENT DEVELOPMENTS IN VERTICAL INTEGRATION

Livestock

Vertical Integration in the livestock industry is being initiated by suppliers of feed, packers or a combination of both. The volume to date is small, but it may increase.

Hogs

At the present time not many swine producers have entered into vertical integration contracts in Ohio. However, the subject is being discussed and questions relative to integration are being asked. In a few areas some farmers are raising hogs under contract.

In most instances, contracts include specifications for quality of breeding stock used, farrowing periods, weight to be

marketed, and, in some cases, will offer certain price differentials for meat-type hogs.

Contents of the contracts vary depending on differences in local conditions. For example, in one area, the grower may have to furnish feeder pigs, all facilities, veterinary services, labor, sell the hogs at a certain weight, and pay for the feed on a cost per 100 lb. gain basis; the cost to be established by a pre-determined formula. The farm supplier would furnish and deliver all grain, supplement and sanitation products and would keep the necessary records.

In other contracts, the farmer might only furnish land and labor while the integrator would furnish all other resources.

If and when integration in the swine industry becomes more prevalent, contracts will no doubt become more uniform.

Some farmers may find it to their advantage to enter into a program others may not. Advantages and disadvantages are listed earlier and should be of help in determining what you may want to do.

Beef and Lambs

Vertical Integration in beef production and marketing is starting in scattered Ohio localities. The operation of large cattle feeding yards in the west is a different operation from the contract arrangements now starting with farmers who feed up to 100 head.

For example, a farmer who has a barn and yard not in use may be interested in signing a contract with a feed dealer who agrees to buy the feeders and furnish the feed for the feeding period. The farmer furnishes the facilities, straw and the labor required in feeding and looking after the cattle. For this the farmer is paid a definite amount such as 10 cents per day per head of cattle.

If the farmer were feeding 100 cattle for 200 days, he would get $10 per day (10¢ X 100 cattle) and $10 X 200 (the number of days the cattle would be on feed) or $2,000 for the feeding period. The integrator would assume the risks. This arrangement may not appeal to all farmers, but the farmer is assured a steady income and no risks.

Meat packers have been feeding lambs for years in the western areas. They have done this to get a supply of lambs for slaughter when farmers, for different reasons, would not furnish finished lambs in sufficient numbers at periods of the

year desired by packers. This is integration, but it does not involve the farmer with facilities on his own farm. Lamb feeding involving farmers who contract with a feed company or processor is not common in Ohio.

Poultry

Broiler production is the first of the poultry enterprises to become vertically integrated on a large scale. Vertical integration in the broiler industry is primarily a result of the contractual arrangements between producers and the allied agencies such as feed dealers, hatcherymen and processors, who are the major sources of credit used in financing broiler production.

Today, over 90 percent of the broilers produced in the commercial broiler growing areas are grown under some type of a contract involving an integrated organization. The credit supplied through these contractual arrangements has made it possible for the broiler industry to expand at a rapid rate and to take advantage of mass production and assembly line techniques used by many manufacturing industries.

There is considerable variation in contracts being offered broiler growers. In most cases, under today's vertical integration set-up, the grower agrees to a pre-determined rate of return for the use of his facilities and labor. The contractor assumes the risks involved in growing the broilers. Usually the grower supplies the building, equipment and labor required to grow the birds. The integrator (feed dealer, hatcheryman, processor or a combination of these) furnishes the chicks, feed and other supplies. The integrator retains ownership of the birds and makes most of the management decisions.

In several of the commercial broiler growing areas, the grower is guaranteed a specified price for each pound of broiler produced plus a bonus based on feed conversion for the use of his facilities and labor. The current rate is around two cents a pound or five cents per bird. The guarantee of two cents per pound may also be increased depending on the price level. In some contracts, the grower receives a guaranteed return plus a share of the profits, if there are any. In other commercial broiler growing areas there are contracts which call for a straight one cent per bird per week payment.

This type of contract in which the grower receives a guaranteed return and the integrator assumes most of the risks has been common in the commercial broiler growing areas for a number of years. Contracts of this kind were not used extensively in Ohio until 1957 when prices became very unfavorable for the independent grower.

Some Ohio growers are receiving a straight 10 cents per bird. Others are receiving 5 cents per bird plus a bonus based on feed conversion and/or a share of the profits.

Vertical integration is also taking place in the growing of turkeys. Many Ohio turkey growers have vertically integrated by acquiring the facilities to process and distribute their own turkeys direct to retailers and consumers. Much of the credit required by Ohio turkey growers is provided through 'open' accounts with feed dealers and other suppliers. Until the present time, the grower has assumed the inherent risk involved in growing the turkeys; but the trend is toward contractual arrangements similar to those used in growing broilers.

Vertical integration is increasing in the production of market eggs. Producers are integrating through direct marketing programs and contractual arrangements similar to those in the broiler industry.

In one of the midwestern states the sponsoring organization loans the producer most of the capital to build a modern poultry house and completely equip it - including ready-to-lay pullets and other supplies. Everything from the building of the house to care of the eggs is supervised by the sponsoring firm. Under this arrangement the grower is guaranteed a minimum price for his eggs.

An organization in another area provides the grower with chicks, feed and medication to raise and maintain the pullets throughout the laying period. The producer provides the housing, poultry house equipment and other supplies. In return for raising the pullets, caring for the laying flock and the use of his buildings and equipment, the grower receives 6 cents for each dozen of clean eggs his flock produces. The producer may also receive an additional bonus (up to 6 cents per dozen) based on mortality, rate of production and feed conversion. All the eggs and birds remain the property of the sponsoring firm.

In Ohio, several feed companies are offering growers 'package deals' which include financing the chicks, feed and equipment such as mechanical refrigeration units and arranging for a market for eggs. At the present time, these firms do not guarantee an egg price or a return to the grower.

Producers of broiler hatching eggs are being offered contracts in which the grower receives a fee (such as 15¢ per dozen) for each dozen of eggs produced in return for his labor and the use of his equipment.

Dairying

Several forms of vertical integration are evident in dairying. Some of these date back many years and are not increasing at this time.

One of the oldest forms is the result of cooperatives moving into the field of processing and distribution of fluid milk. In this case, farmers through their cooperatives have assumed all the functions of processing and marketing. In Ohio, the Cincinnati Pure Milk Association is an example of such a move dating back to the early 1930's. Other cooperatives have assumed various positions from a small degree of integration to complete vertical integration. For example, some cooperatives have taken over the transportation of milk from farm to market while others have acquired facilities for processing surplus milk or are active in purchase of dairy supplies such as furnishing bulk tanks.

In the processing field, too, there are examples of vertical integration. These developments are mainly in two areas. First, chain store operators have become interested in processing milk to be sold through their own stores. There are examples of such operations in Ohio, but certain food chains operating on both the East and West coast have been much more active in this area during the past several years than have Ohio firms.

The second form of vertical integration affecting the sale of milk has taken place where processors have acquired stores through which they sell their products. Such operations are fairly well established in Ohio.

Fruits and Vegetables

Vertical Intregation has taken many forms in the fruit and vegetable industry. The most typical and fully developed area has been in the processing crops. In these, the processor is the agency largely responsible for the integration.

The processor normally determines the price that he will offer and the acreage he will produce. He also specifies the variety, when to plant and when to harvest the crops being grown. In addition to this, he usually recommends fertilization practices and other growing practices which he feels will help make the crop come up to his specifications.

The grower who accepts a contract is a free agent mainly to the extent that he can decide whether to grow this crop on the terms specified or grow another crop on his land.

There has been some integration through growers' cooperatives. These cooperatives allow the growers to carry the marketing of the product through packaging and/or the selling of the crop. Examples of this are found in the tomato industry (both greenhouse and field) in the potato industry and in the fruit industry.

In the potato industry, the integration is least pronounced with the cooperative association acting only as a quality control and sales agency. The organization specifies the grade and sees to it that only the specified grade is sold under the association brand.

A few grower cooperatives operate wholesale fresh produce firms. In these, the degree of integration is extremely limited, allowing the grower to have control over the produce through one more step in the marketing process.

The future of integration in the fruit and vegetable industry would appear to be greatest in the processing field. Potato chip processors have been moving into storage of potatoes in the fall and into formal or informal arrangements with producers for growing potatoes for chipping.

The advantages of this type of organization in the potato chipping industry would not appear to be as great as in the sweet corn or tomato processing field, but would still appear to have advantages that would cause its growth. One alternative would be for a grower organization to serve the processor's interest. Another alternative would be for the grower to become also a processor of potato chips. This would involve many management and policy decisions and does not appear to be a likely procedure.

It would appear that the chances for further integration in other fruit and vegetable crops in Ohio are somewhat limited, since other states and areas generally have production advantages.

Another method of integration has been the production of the crop by the processor. A considerable amount of this kind of integration occurs with the sweet corn canner and with the potato processor. The processor plans an approximate acreage that he will produce on his own and fills out his remaining needs through contracting with growers, or the processor contracts with growers for the quantity that he can readily obtain and then plans on filling his remaining needs by production on his own acreage.

In the case of the potato processor, the supply often is obtained outside of Ohio for processing during a period when Ohio potatoes are not available.