Industrial Hemp Production: Risk Management

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Introduction

As prices for Oklahoma field crops have remained depressed, a new opportunity and hope of financial gain has garnered a more detailed look at industrial hemp. The 2018 Farm Bill established a legal definition of industrial hemp as based on delta-9 tetrahydrocannabinol (THC) concentration of not more than 0.3 percent on a dry weight basis, which legally differentiates hemp from marijuana and allows the purchase of viable hemp seed. Consequently, the 2018 Farm Bill removed hemp from the list of controlled substances under the Controlled Substances Act. Industrial hemp production is an opportunity that comes with risk as well. Risk will always be a part of commercial agriculture. Over time, tools have been developed for farmers to mitigate that risk. Many of those tools are not available for industrial hemp producers due to limited data and research in the various growing regions of the US. Using a template from Purdue University, risk types can be categorized into three segments: Business, Financial and Strategic Risk[1].

Business Risk

Business Risk involves the chance of any adverse result from the practice of planting, growing and marketing hemp. Some of the most daunting risks come in the production of the actual crop. To date, our agronomic information (varieties, planting specifications, herbicides, etc.) as to how hemp will perform in Oklahoma is very limited. Crop insurance is used in many field crops to lessen the negative financial impact of a crop failure or poor yield. Unfortunately, this will not be an option in the summer of 2019 due to there not being enough time to develop a hemp crop insurance program[2]. Rain, weed pressure or destruction due to THC levels could result in total financial loss unless somehow addressed in the production contract. It is important to consider both the capital invested in the current crop and the forgone revenue/cost from a crop that could have been planted instead when making a planting decision.

Price and marketing risk are a concern with emerging crops as well. Most hemp production is expected to occur under contract, which will include a financial agreement. Initially, this would ease the minds of the more risk-averse producer that observes the fluctuations of commodity prices through the year. Contract production is very common in Oklahoma, especially in the poultry and swine sector. These contracts are generally made with mature, financially stable companies that have weathered the financial storms of production agriculture. A promise of payment is only as valid as the issuer of the contract. The risk of the other party in the contract not fulfilling their obligation (counter-party risk) could be prevalent in the initial years of production. Crop ownership rights, price and delivery specifics are a small sample of contractual issues that need to be addressed. Above all, have your attorney review all production contracts before entering into an agreement. Additionally, there is risk of oversupply in the market, particularly in the initial years after 2018 Farm Bill and HB 2628 implementation[3]. Assuming hemp functions as an inelastic ag commodity, this oversupply will have negative impacts on farm revenues via lower prices.

Strategic Risk

Logistical considerations and processing capacity should develop and stabilize as the hemp market matures. The infrastructure of processors in Oklahoma is not developed. Currently there is one hemp fiber processor in Oklahoma; in addition, three other processors are either in production or building production for oil and CBD production. This issue will be magnified if planted acres increase rapidly. If the company that a producer entered a contract with has halted its operations, there will likely be few options to market a crop. Market price information for hemp fiber, seed, etc. also will be a hurdle. Contract production hampers the visibility of commodity prices because they are not bid for or auctioned.

The discovery of current prices on traditional commodities is as easy as calling a co-op, livestock auction or pulling up an app on your phone. The producers of an emerging commodity may not enjoy that luxury early on. The lack of cash market prices makes it more difficult to determine if the price being offered in a contract is appropriate.

Financial Risk

Financial risk is the next component to evaluate. OSU Extension Fact Sheet AGEC-790 *Evaluating Financial Performance and Position* provides useful insights to calculate and manage your financial position. In the short term, maintaining working capital is very important. Working capital is the difference between current assets and current liabilities. This will provide a dollar figure for use in cash flow estimation. The current ratio can be used as well as a short-term measure. Working capital and current ratio together demonstrate the farm's ability to generate cash by reserves or sales. The take away is that maintaining enough current assets to cover the short-term obligations will be an initial goal. For example, if a producer plants a crop and it fails, will the cash invested in the crop cause financial distress to the family by hindering the ability to meet debt obligations or family withdrawals? Short-term impacts will be felt relatively quickly, but keep an eye on long-term solvency as well. To effectively assemble a budget for an upcoming planting season, it is advised to pencil in with reasonable accuracy revenues and expenses. The lack of production cost history combined with limited yield information limits the analysis of the enterprise at the beginning.

Conclusion

There are limited options to mitigate risk in industrial hemp for the 2019 growing season. First, maintain a diverse set of income streams. Diversification is one of the primary components of risk management in many businesses. That may mean maintaining a balance of summer crops to spread risk amongst multiple crop systems. Next, negotiate up-front money to compensate for your likely expenditures. Lastly, know and maintain your working capital for the growing season.

References

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