



NC State Tobacco Connection

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New Opportunities for Flue-Cured Tobacco and Production Decisions

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Quick Hits

- 201 production was at 452 million pounds. Potential increases for 2011 could be 25-30 percent.
- A new buyer has emerged for the export market and indicated they would like to purchase at least 100 million pounds for the Chinese market.
- Investment in new curing barns is estimated to cost \$260 per acre, assuming 5% interest and curing 10 barns per acre per year.
- Growers should compare the potential returns of other crops they could grow. In other words, what are your alternatives to growing more tobacco?

The outlook for the 2011 crop of flue-cured tobacco is turning out to be a little brighter than it was for last year's crop. First, several traditional buyers of U.S. tobacco for export have indicated that they intend to purchase more tobacco in 2011. Second, a new buyer for export has emerged and has indicated that they would like to contract for 100 million pounds to sell into the Chinese market. With 2010 production at 452 million pounds, the potential increase in sales could be 25 to 30 percent. Producers face a number of important questions in trying to decide whether or not to produce additional tobacco for the new buyer.

The first question is "are the buying company and contract offered credible?" I cannot answer this question, but given that the company has purchased other agricultural commodities for export, seeking the advice of farmers who have done business with the company is advisable. Another helpful question is "who is the customer to which the company intends to sell the tobacco?" Also, does the contract provide an out for the producer or for the buying company if their intended market does not materialize?

ducer have to invest in any new equipment to produce additional tobacco? If so, this indicates a multi-year commitment to producing and selling more tobacco. For example, suppose you can purchase a used barn for \$20,000. If you think of the barn as having a useful life of 10 years (the barn may last 20 or more years, but given the uncertainty surrounding the tobacco industry you probably want to recoup your investment in a

shorter period of time), if you assume an interest rate of 5 percent, and you cure 10 acres per barn per year, then the annual cost of the barn is about \$260 per acre. Do you feel confident enough

"A new buyer for export has emerged"

Given the uncertainty that producers may feel surrounds a new buyer there are some constructive ways to frame a decision. First, will the pro-

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NEW OPPORTUNITIES (CONT'D)

about the longevity of the contract with the new company to incur \$260 per acre per year in fixed costs plus the annual operating costs of production in order to grow the additional tobacco?

A more likely scenario for most growers is one in which they have extra curing capacity and do not have to purchase additional equipment. Many growers experienced a reduction in contract pounds in 2010. In this case no additional fixed costs would be incurred so the question is “Am I willing to incur the additional operating (out-of-pocket) costs required to grow the additional tobacco?” The NCSU flue-cured tobacco enterprise budget indicates that production costs are about \$2,700 per acre. Using the 5 year average yield for N.C. flue-cured tobacco of 2,226 pounds per acre gives an operating cost of \$1.21 per pound. So the breakeven price for just recouping operating costs is \$1.21. Each producer should know and use his or her own operating costs and yields in calculating their breakeven price.

Obviously, one of the biggest concerns for a producer is “what if I grow the tobacco and then the company does not buy it?” How would you handle it if this worst case scenario happened? You could sell the tobacco to someone, but it might be at a greatly reduced price. For example if you could only sell it for \$0.70 per pound (I do not know what the price might actually be in this sort of worst case scenario), then you would lose \$0.51 in out-of-pocket costs for every additional pound you produced. Another option might be to store the tobacco rather than sell it at a low price. This option carries its own risks. You would want to feel confident that the tobacco bales would store well, that the extra tobacco would fit in with your 2012 crop throw, and that you have a buyer in 2012 that would buy carryover tobacco.

In making the decision to grow additional tobacco the producer must decide how likely he or she thinks this worst case scenario might be. This is at best an educated guess. You must then decide how much financial hardship a financial loss and/or deferment of income would bring to your operation. Obviously you need to make sure you could cash flow in 2011 if you sold the tobacco at a loss or stored it for later sale. In trying to answer these questions, you can then decide how many pounds you could risk growing.

Finally, if you decide you can stand to take the risk of growing additional

Unfortunately there is no easy or certain way to answer the question of “Should I grow additional tobacco for a new buyer in 2011?”

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NEW OPPORTUNITIES (CONT'D)

pounds, you must compare the potential return to other enterprises, such as other crops you could grow. In other words, what are your alternatives to growing tobacco? Fortunately commodity prices are strong, so farmers do have better alternatives than usual. At the time of writing, 2011 crop cotton could be booked for about \$1.00 per pound and corn for about \$6.00 per bushel. Suppose a cotton yield of 800 pounds per acre (the N.C. 5 year average is 844 pounds) and operating cost for an acre of cotton of \$525 per acre. The gross revenue under this scenario is \$800 per acre so that the return over operating costs per acre is \$275. Suppose a tobacco yield of 2,300 pounds per acre (slightly better than average) and a price per pound of \$1.75. Revenue per acre is then \$4,025. With operating cost of \$2,700 per acre the return over operating costs per acre is \$1,325. Based on these estimates then you would have to add about 48 acres of cotton to equal the return over operating costs for 10 acres of tobacco. The question then becomes (given that land and equipment are already available for both cotton and tobacco) which would you rather do, grow an additional 10 acres of tobacco or an additional 48 acres of cotton? Which is the best use of your time and management?

We can also consider the effect of land rent. What if land rent is \$100 per acre, then return over operating expenses and land rent per acre for cotton is \$175 and \$1,225 for tobacco. Considering land rent (assuming equipment is available for both tobacco and cotton), it will take 70 acres of cotton to equal the return over operating and land costs for 10 acres of tobacco. Again, the question becomes which would you rather do grow an additional 70 acres of cotton with a certain price and market or an additional 10 acres of tobacco with some uncertainty surrounding the market? You can use this exercise with any enterprise. If you have to buy additional equipment, then the additional annual cost must be included in the calculations.

Unfortunately there is no easy or certain way to answer the question of "should I grow additional tobacco for a new buyer in 2011?" How risky is this new contract? How much risk can I afford to take and be comfortable with? How do potential returns on alternative enterprises compare with tobacco? Doing some research and thinking through these questions in a logical manner can help you make a reasonable decision.

US Flue-Cured Tobacco Update

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Market Situation

According to USDA, U.S. flue-cured tobacco harvested acreage was estimated at 211,000 down 13,000 acres from 2009. Acreage had declined to a low of 174,500 in 2005 before it climbed to 224,000 in 2009. Estimated 2010 average yield per acre was 2,148 pounds down from 2,346 pounds in 2009. The 2010 U.S. flue-cured crop production estimate was 453.08 million pounds, down 15% from 526.4 million pounds in 2009. According USDA-NASS North Carolina acreage was 166,000 acres, down 8,000 acres from 2009. Production in North Carolina was estimated at 348.6 million pounds, down 16 % from 2009. The North Carolina 2010 crop was reported to be spotty and late in many areas. Most farmers reported lower quality with some saying this was their worst crop ever. This was primarily due to dry weather which lowered average yields substantially. The Center for Tobacco Grower Research (CTGR) (www.tobaccogrowerresearch.com) reported results from a 2010 phone survey of 154 flue-cured growers in which 36% of growers responding considered the overall quality of their 2010 crop "average," 30% considered it "below average," and 13% considered it "poor."

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FLUE CURED UPDATE (CONT'D)

Table 1: U.S. Flue-Cured Tobacco Production, 2004 to 2010, in million pounds.

	Florida	Georgia	North Carolina	South Carolina	Virginia	U.S. Total
2004	9.8	46.7	344.0	63.4	57.6	521.5
2005	5.5	27.8	273.9	39.9	33.7	380.8
2006	2.9	30.1	324.0	48.3	42.0	447.2
2007	n/a	39.8	376.8	46.1	41.0	503.8
2008	n/a	33.6	384.7	39.9	41.0	499.2
2009	n/a	28.0	417.6	38.8	41.0	525.4
2010	n/a	27.4	348.6	36.0	41.1	453.1

(Source: USDA, NASS, *Crop Production Report*, January 2011)

According to the CTGR 2010 phone survey 43.5% of growers surveyed reported a reduction in their 2010 contract relative to 2009. Of those reporting that their 2010 contract was cut, they reported that, on average, their contract was cut 21 %. About 32% of the 154 flue-cured growers surveyed indicated that their contract pounds were unchanged for 2010 and slightly over 20% reported an increase in pounds under contract. If the survey is representative of flue-cured growers, then it implies a reduction in contracted pounds overall of 7-8%. Other reports from industry and farm groups indicate that primary contracts were down around 20%. The survey may have included secondary contracts causing the reduction in contract pounds reported to be lower than 20%. Also some farmer lost contracts which may not have been reflected in the survey results.

Expectations were that domestic manufacturers would need less tobacco due to increased cigarette taxes and in anticipation of implementation of FDA regulation. However, the cut backs and closures of some buying stations by the largest export customer were unexpected. This appeared to be a global decision perhaps reflecting declines in cigarette consumption in developed country markets around the globe. At the same time another export buyer opened a processing facility in Virginia. Purchases by this buyer may have been up partially offsetting decreased purchases by other buyers.

With the 2010 crop down only 15 percent, but contracted volume perhaps down 20 percent, excess supply may have been problematic for the 2010 market. This combined with quality problems are likely reasons for depressed 2010 crop prices. Farmers reported lower prices mainly due to receiving lower grades for tobacco than last season. Some growers sold a portion of their crop via a secondary contract and a few growers sold their entire crop in this manner. The secondary contracts were with leaf dealers usually at a lower price than primary contracts. Some farmers sold a portion of their crop via silent auctions. Prices in the auctions were reported to be substantially lower than contract prices. It appears this accounted for only small portion of production.

Flue-cured tobacco market prices are difficult to estimate since all flue-cured tobacco is grown on contract. However USDA-NASS reported an average price per pound of \$1.754 for the 2009 crop. Prices are expected to have been lower for the 2010 crop. The average price may have been as low as \$1.70 per pound.

USDA no longer tracks world tobacco production. Global flue-cured tobacco production was expected to be 9.9 billion pounds

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FLUE CURED UPDATE (CONT'D)

Table 2: Flue-Cured Tobacco Production, Stocks, Supply and Disappearance (farm sales weight million lb)

Marketing	Beginning	Produc-	Total Sup-	Ending	Total Use	Exports	Domestic
2004-2005	822.8	499.3	1,322.2	796.0	526.2	188.6	337.6
2005-2006	796.0	380.9	1,176.9	604.0	572.8	258.4	314.4
2006-2007	604.0	446.5	1,050.5	493.2	557.3	247.0	310.3
2007-2008	493.2	503.8	997.0	396.8	600.2	305.0	295.3
2008-2009	396.8	499.2	896.0	360.3	535.6	304.2	231.5
2009-2010	360.3	525.4	885.7	398.8	486.9	303.1	183.7

(Source USDA-AMS Tobacco Stocks as of October 1, 2010. TOB-210. November, 2010. USDA-FAS.GATS)

in 2010, up almost 4% from 2009 according to Universal Tobacco Company's November 3, 2010 issue of "World Leaf Production." Production was up in China for the second consecutive year and estimated to be about 5.42 billion pounds. Brazilian flue-cured production (the chief competition to U.S. flue-cured) declined from 1.340 billion pounds in 2009 to 1.25 billion pounds in 2010. The declines in both Brazil and the U.S., the two primary exporters of premium flue-cured tobacco, indicate a drop in supplies of premium style flue-cured. This decline in supply was in part due to weather, but may also be due to declining demand in developed country markets such as the U.S. and Europe.

Total use of flue-cured tobacco (use by domestic manufacturers plus exports) was down for the 2009 -2010 marketing year. This was due to lower domestic use. Exports rose from a low of 188.6 million pounds in the 2005-2006 marketing year to 305 million pounds in the 2007-2008 marketing year. Exports were about the same in the 2008-2009 marketing year at 304 million pounds. Exports of unmanufactured flue-cured tobacco are down slightly for the 2009-2010 marketing year at 303 million pounds. The low value of the dollar has favored exports. With lower demand from both domestic and export buyers for the 2010 crop, both domestic use and exports may be lower for 2010-2011.

A global trend in restrictions on flavorings in cigarettes could cause a switch toward Virginia style cigarettes that contain more flue-cured tobacco. This could partially mitigate the impact of declining demand in developed countries due to increased regulations and restrictions, increased taxes and continued health concerns. Much uncertainty remains as a result of both FDA and the World Health Organization Framework Convention on Tobacco Control regulations.

FDA Update

Thus far in implementing the *Family Smoking Prevention and Control Act* FDA has established a Center for Tobacco Products, set up a Tobacco Products Scientific Advisory Committee, banned flavorings, with the exception of menthol, in tobacco products, banned designations such as "Light," "Mild," or "Low" and issued new warning labels, proposed graphic warning labels, begun a study on whether to restrict or ban menthol use in cigarettes, developed a list of harmful constituents in cigarettes, required tobacco product manufacturers to report all ingredients, initiated a study by the National Academies of Science on reduced risk tobacco products, and begun levying fees to pay for regulation of tobacco products. During 2011 the FDA Tobacco Products Center is expected issue regulations for graphic warning labels on cigarettes, issue a ruling on menthol use in cigarettes, and establish pesticide limits on tobacco. At some point in the

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FLUE CURED UPDATE (CONT'D)

future FDA will begin requiring manufacturers to test for harmful constituents and may regulate the levels of certain harmful constituents.

While tobacco is not regulated directly at the farm level, regulations setting pesticide limits in tobacco and regulations regarding harmful constituents will impact the farm via requirements passed down by manufacturers. Reductions in demand due to increased regulation are already manifested in lower domestic use by U.S. cigarette manufacturers. Due to the uncertainty surrounding FDA regulation of tobacco products manufacturers are making very conservative business decisions. This includes purchases of tobacco since manufacturers want to minimize stocks of tobacco that might not meet as yet unknown requirements under FDA.

2011 Production and Prices

At writing only a couple of buyers had given indications of prices for the 2011 crop. However, export demand seems to be stronger this year relative to 2010. Indications are that at least three traditional foreign buyers will increase purchases. The total increase from just these three buyers could mean a 25-30 million pound increase in contracted pounds. Even though demand fell for the 2010 crop, a smaller than expected supply of flue-cured last year due to poor 2010 U.S. and Brazilian crops may have bolstered demand for tobacco in 2011. As such this could be a one year increase rather than a permanent increase. Other buyers were in the process of signing contracts with growers at the time of writing.

The big news in the U.S. tobacco market is the emergence of a new buyer offering contracts for a supposed 100 million pounds of flue-cured tobacco for export to China. The China National Tobacco Corporation and the State Tobacco Monopoly Administration have indicated that they have no knowledge of the new buyer. This leaves growers wondering to whom the new buyer will export tobacco. The

new buyer has already signed contracts for substantial quantities of tobacco. The most important unanswered questions are whether or not this new demand is real and whether it will persist beyond 2011.

Could the U.S. produce an additional 100 million pounds of flue-cured? The U.S. produced 526 million pounds of flue-cured on 224 thousand acres in 2009; the largest acreage since 2004. Yields were above average in 2009. With 224 thousand acres of production and the 5-year average yield of 2,226 pounds per acre, production would be 498 million pounds. Quantity demanded at contract prices going into the 2010 season may have been about 460 million pounds. Suppose demand at current prices from traditional buyers is up 30 million pounds for 2011. Under this scenario production of 490 million pounds would be needed to satisfy demand from traditional buyers.

Is there curing capacity beyond 224 thousand acres? Some 2009 growers lost contracts and dropped out of tobacco. According to the Center for Tobacco Grower Research (CTGR) 43 percent of growers in 2010 experienced an average reduction in contract pounds of 21 percent. So the important questions are 1) was there excess capacity in 2009, and 2) how much capacity was lost in 2010? While the answer is uncertain, the 224,000 acres grown in 2009 is likely the upper limit of current capacity. Unless there is evidence that the 2011 increase in demand is permanent, it is unlikely that new equipment will be manufactured or purchased to increase current capacity.

Convincing growers to grow more tobacco is not just a question of capacity. Strong commodity prices for corn, soybeans and cotton make them viable alternatives for tobacco. At writing 2011 crop cotton could be booked for around \$1 per pound in North Carolina. While some cotton producing areas have limited gin capacity for expansion,

FLUE CURED UPDATE (CONT'D)

North Carolina has much unused gin capacity, placing NC farmers in a good position to increase cotton production. The 5-year average yield for NC cotton is 844 pounds per acre. If farmers book cotton at \$1 per pound, then potential revenue per acre is \$844. Operating costs per acre are around \$525 and land rent around \$100. This leaves a potential \$244 per acre return to equipment and management for growing an acre of cotton. Using the 5-year average yield for tobacco of 2,226 pounds per acre and a price of \$1.75 per pound means expected revenue on an acre of tobacco is about \$3,895. Using an estimate of operating costs per acre of \$2,750 and land rent of \$100 gives a return to management and equipment per acre of flue-cured of \$1,045. This means that 43 acres of cotton will yield an equivalent return to management and equipment as 10 acres of tobacco. The question for eastern NC growers that have equipment to grow extra tobacco or cotton will be would I rather grow an extra 43 acres of cotton or an extra 10 acres of tobacco?

Obviously piedmont growers may not have such opportunities so expansion of tobacco production may be a question of do I have extra curing capacity and can I get enough labor to grow more tobacco? H2-A labor wage rates will increase around \$2 per hour this season. The labor situation also decreases the attractiveness of expansion of tobacco. Buyers who are requiring that tobacco be grown free of maleic hydrazide (MH) or other special requirements may have trouble getting the pounds they desire unless prices paid reflect the higher cost and management requirements of this tobacco.

With limited capacity to expand and viable alternatives to tobacco production in eastern NC, competition among buyers for the 2011 flue-cured crop could be intense. This logically should bolster prices. Some buyers have already indicated that they will pay higher prices for the coming crop. Indications are that other buyers are offering prices similar to those offered in 2010 contracts. Whether prices are higher for the 2011 season is yet to be seen. Further we are still waiting to see what quantities domestic buyers will want this year amid another year of uncertainty with FDA regulation.

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Universal Leaf Tobacco Company. "World Leaf Production." August 3, 2010. Accessible at www.universalcorp.com/Reports/SelectReport.asp?ID=725&Menu=Tob.

Extension Personnel Working With Flue-Cured Tobacco

County	Agent	Phone
Alamance	Roger Cobb	336-570-6740
Alexander	Allison Brown	828-632-4451
Anson	Janine Rywak	828-694-2915
Beaufort	Gaylon Ambrose	252-946-0111
Bertie	Jacob Searcy	252-794-5317
Bladen	Ryan Harrelson	910-862-4591
Brunswick	Al Hight	910-253-2610
Caldwell	Seth Nagy	828-757-1290
Carteret	Regina Bell	252-728-8421
Caswell	Will Strader	336-694-4158
Chatham	Sam Groce	919-542-8202
Chowan	Vacant	252-482-6585
Columbus	Michael Shaw	910-640-6605
Craven	Mike Carroll	252-633-1477
Cumberland	Colby Lambert	910-484-7156
Davidson	Troy Coggins	336-242-2083
Davie	Phil Rucker	336-753-6100
Duplin	Curtis Fountain	910-296-2143
Durham	Delphine Sellars	919-560-0526
Edgecombe	Art Bradley	252-641-7815
Forsyth	Tim Hambrick	336-703-2850
Franklin	Tyrone Fisher	919-496-3344
Gates	Reba Green-Holley	252-357-1400
Granville	Molly Buckham	919-603-1350
Greene	Shenile Ford	252-747-5831
Guilford	Wick Wickliffe	336-375-5876
Halifax	Arthur Whitehead	252-583-5161
Harnett	Brian Parrish	910-893-7530
Hertford	Jacob Searcy	252-358-7822
Hoke	Keith Walters	910-875-3461
Iredell	Ken Vaughn	704-878-3153

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Lenoir	Mark Keene	252-527-2191
Martin	Al Cochran	252-792-1621
Montgomery	Roger Galloway	910-576-6011
Moore	Taylor Williams	910-947-3188
Nash	Charlie Tyson	252-459-9810
Northampton	Craig Ellison	252-534-2711
Onslow	Melissa Evans	910-455-5873
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Pamlico	Bill Eilers	252-745-4121
Pender	Mark Seitz	910-259-1235
Person	Derek Day	336-599-1195
Pitt	Mitch Smith	252-902-1702
Randolph	Adam Ross	336-318-6002
Richmond	Tiffanee Conrad-Acuna	910-997-8255
Robeson	Cathy Graham	910-671-3276
Rockingham	Will Strader	336-342-8230
Sampson	Keith Kettner	910-592-7161
Scotland	Sharon English	910-277-2422
Stokes	Tim Hambrick	336-593-8179
Surry	JoAnna Radford	336-401-8025
Vance	Molly Buckham	252-438-8188
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Warren	Paul McKenzie	252-257-3640
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