

By Jeff Atkinson & Diana Klemme

Mom and Darlene
Discuss Risk:

To Hold or To Fold

It's a warm spring day. Mom's back from her condo at the lake and Darlene's been invited to the house for a talk. Mom is the majority owner of Mom's Grain, a mid-size country elevator in the Midwest. Darlene is the general manager and a minority stockholder. Mom's sitting on the front porch studying what looks like house plans with her longtime companion Charlie. She greets Darlene and they walk into the study.

As Darlene's ownership in the business and Mom's confidence in her have increased, Mom has become a semi passive investor. She looks at her watch; "Charlie and I are renovating a big old lake house so we can have all the grandkids down to visit. We have a meeting with the contractor in about an hour. Meantime, tell me what's happening."

"It's great that you guys are keeping busy," Darlene smiles. "I think the biggest development over the past year or two is in what I'd call industry wide risks."

Basis risk. "It's become more risky to count on historical basis levels, geographic basis relationships, and even seasonal basis patterns. One reason is growing and shifting domestic consumption, mainly due to ethanol. Two plants within 25 miles of us broke ground this month. They'll produce 200 million gallons and consume 70 million bushels. That doesn't mean basis will be high, though, just high enough to keep that corn local and away from our train markets.

"My challenge is how to operate our facilities most effectively because I can't make those plants go away. I have some ideas but I'll go over those with you next time.

"I can at least hope to figure out and deal with the ethanol plants. They'll buy corn, we sell corn — must be some opportunities there. The one that really worries me is the impact of "big money" in futures. Like most country elevators, we tend to trade from long basis positions much of the time. Now we're carrying a lot of '08, '09 and even 2010 crop purchases, primarily corn. The risk from basis moves of 2 to 25¢ probably hasn't increased. But I think the risk of having a 25 to 50¢ move has. And, whereas I used to think of huge basis moves, say 75¢ or more, as being impossible, I'm not so sure anymore. You and I've talked about 'big money' in futures. Some say it's over \$100 billion and growing, just in index funds with holdings scattered

among various commodities. Even pension funds are starting to allocate a small percentage of their holdings to commodities and some of that's coming to ag commodities. I never thought I'd live to see that day, but it's here. What's next, our employees' IRAs?" Darlene chuckles.

"These index funds are exclusively long. As I see it, the result has been higher futures and somewhat lower basis than would otherwise be the case. So far, I don't think it's been a problem, except perhaps in soft red wheat. That's because the 'big money' is investing generically in wheat, but CBOT futures should reflect the value of the subclass of soft red wheat. You taught me years ago that the cash price is the true value of something, what somebody's willing to pay to own it. Futures reflect the broader consensus of buyers and sellers here and abroad, speculators and hedgers. In CBOT wheat, futures raced ahead of cash values last year and left a lot of farmers and elevators wondering why basis didn't 'work.'

"But once low basis widens spreads to offer attractive yields from holding CBOT delivery certificates for redelivery later, there's little to keep futures prices from rising further above cash values. I worry about a scenario where futures explode higher, and futures and cash disconnect. Could happen this year in corn, you know. We could experience a basis meltdown that takes our breath away, along with a lot of our capital. Even if basis comes back after a time, marking interim losses to market could trash our balance sheet. I'm not saying that scenario is probable, just that it is a risk in this environment.

"I got a copy of this three-market basis chart at a meeting recently — it's interesting information. See how in '05 the interior basis values fell to bigger negative values? That's partly from higher barge freight after Katrina, but Big Money's been buying corn futures since then as well, and cash may already be lagging futures in corn as a result."

Liquidity, interest and counterparty risk from rising futures. "A sharp run-up in futures could hurt us in other ways. At some point, funding margin calls would become a problem. Our bankers will work with us to a point but big increases in inventory and open contract equity will decay our liquidity ratios quickly. Our lender only credits us 50% of the value of forward purchases. Also, as we've talked about before, it would

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get expensive in terms of interest costs and increase our contract default risk. I hear some elevators already have farmers trying to walk away from those \$2.50 forward sales that looked good once."

Mom leans back in her chair, "Hate to think about farmers defaulting, but don't forget about the risk of a buyer getting in trouble. Credit demands will stretch everybody this year. Do you spread

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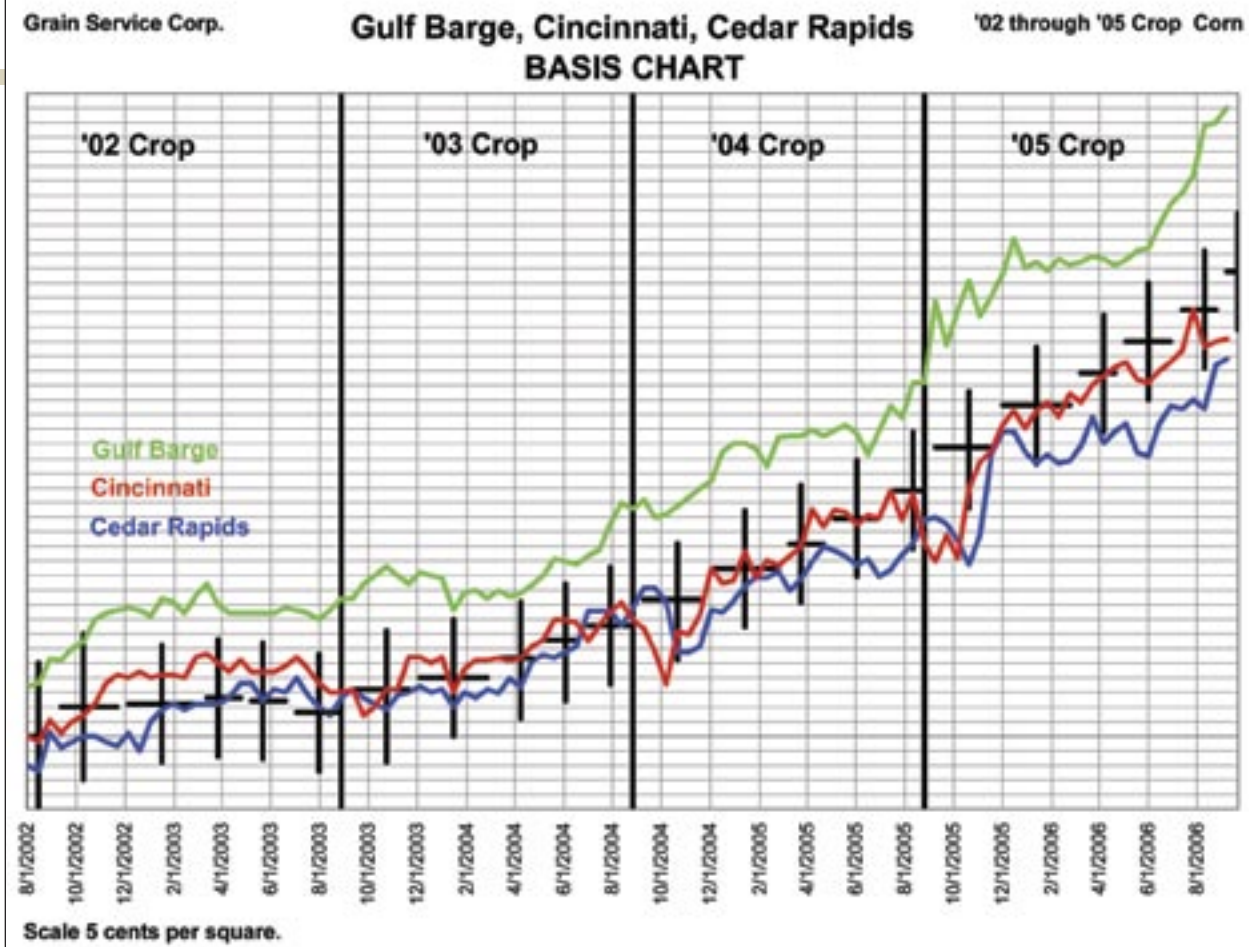
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Each vertical "thermometer" represents the nearby futures contract month. On June 1, 2006, that was July 2006 futures and the chart shows the Cincinnati corn basis was approximately 15 July that day.

your sales among buyers, put your eggs in a lot of baskets, so to speak?"

Darlene nods, "You bet. And I've even invested in a fireproof safe to store all original signed contracts. I'd hate to think what might happen if we had a fire and word got out that all our contracts were destroyed."

Asset obsolescence. "Moving on, we've made big investments in assets that enable us to load big trains for distant markets. Those assets make it possible for us to handle more corn at harvest and to handle corn from farm storage after harvest. But these assets only have value to the extent that our area is surplus. Once these ethanol plants come online, the earning potential and value of our assets will fall. Our

receiving and storage assets would still have value but our marked-to-market net worth will drop."

"So what are you doing about it," Mom asks.

Darlene pauses. "Wider margins and higher fees are part of the answer, and I've done that. I raised storage and drying rates, instituted escalating service fees on any purchases for future crop years. Seriously, I'm doing what I can to strengthen our balance sheet. We can defer capital expenditures and hoard cash, for awhile at least. Some financial folks are offering repos that lock in inventory financing costs and shed some of the risk from higher futures. We're keeping long-term basis positions somewhere between conservative and timid. We're monitoring contract default exposures and offering financial incentives for farmers to do MPCs; the farmer gets a higher basis on MPCs. Ideally, I guess we like them to do MPC HTAs. About the only way to avoid most of these risks is to back away from business, though, and that doesn't work long-term."

Mom sits awhile before speaking.

"Perhaps you should be a little more conservative and more selective about the business we take on. But I agree; if we go too far down that road our competi-

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tion will eat our lunch. We can delay making capital investments and build up capital reserves. But before too long, that too will make us less competitive. I don't like strategies that make Mom's

worth less as a going concern. Diversification is the classic way to manage financial risks. You and I both have most of our capital and net worth in Mom's. Perhaps a more diversified investor should

own it. Some of the 'Big Money' that's buying futures is also buying U.S. farmland, and some banker friends I play golf with tell me the money's looking at acquiring elevators as well.

Darlene says, "I'll check with some of my New York contacts and find out what kind of sale/ leaseback deals might be out there. It would let us cash out and have a nice nest egg. Lots of things to consider, though. If we sell, even with a leaseback and assurances, no telling what could happen. We've worked 20 years to build this business and a lot of folks depend on us. And you look kinda young to retire," she concludes.

Mom's eyes twinkle but with a note of seriousness.

"But on the other hand, higher crop prices and more acres mean a lot more money will flow into the grain sector. Corn acres could be up 15% around here just this year and that means volume. Risks are increasing, but so are potential returns. Short-term, our capital needs could grow faster than our equity. Managing the risks and preserving our liquidity are crucial. If we can do those, the next few years could be our best."

Charlie comes to the door and points at his watch. Mom turns to go, "I'll check around, but don't worry – nothing happens without your input. You and I will talk when I get back. Good luck!" ■

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