

MERCHANDISERS' CORNER

By Diana Klemme



"Come writers and critics
Who prophesize with your pen
And keep your eyes wide
The chance won't come again
And don't speak too soon
For the wheel's still in spin
For the times they are a-changin'"

Excerpt: 1964 – Bob Dylan

Bob Dylan certainly wasn't thinking about the grain industry when he wrote "The Times They Are A-Changing" but the lyrics are surprisingly relevant in 2008. The financial sector is in turmoil, inflation is the highest in over a quarter century, record commodity prices are straining our industry's ability to finance itself, and there'll soon be major changes in Washington — regardless of who wins the November elections.

The grain industry is struggling to cope with an onslaught of changes, and almost inevitably there will

be winners and losers. As Dylan said, "*The slow one now will later be fast, and the first one now will later be last.*" That may overstate the impact on grain firms and there's no inference that any particular firm will be "last." People and firms adapt to change in different ways — small firms as well as large firms can prosper in tough times, and any firm can fall victim to forces they weren't prepared for.

The broad outlook for the grain industry is great: The world needs U.S. production to increase, exports will remain strong, and the demand for elevator services will also be strong. Investment capital is rapidly moving into agriculture, buying land, buying grain elevators and related assets. Some firms are highly profitable this year. But some firms may not be able to adapt to the new demands of grain markets, producers and a new set of competitors.

This "new order" will look on the surface much like the current one: grain bins, ethanol plants, export facilities, feedlots, trains and trucks — all receiving, moving



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or processing billions of bushels of US grains and oilseeds. But behind the scenes the “new order” is changing rapidly.

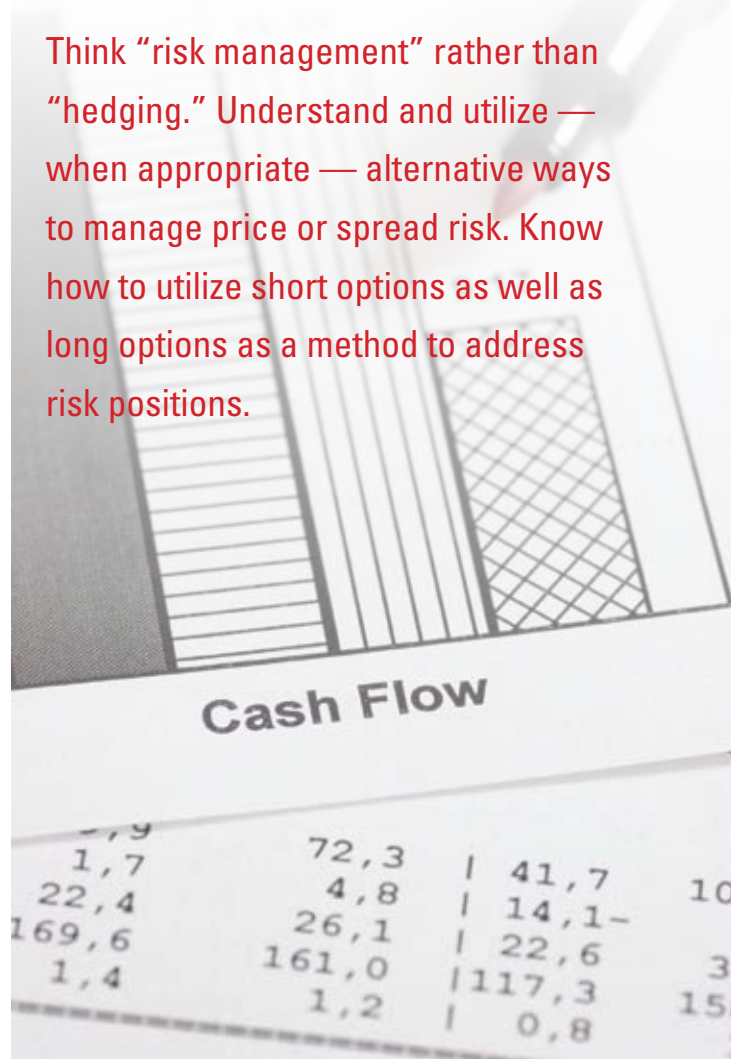
- Operating costs are soaring, from energy, fuel, petroleum-products and staff-related expenses.
- The need for credit and other financing is at record levels and is likely to remain extremely high.
- Business risk is soaring: including market risks, contract and counterparty credit risks.
- Existing “tools” are not always adequate or may be inappropriate when addressing the demands of today: hedge strategies, producer origination approaches, management policies, traditional sources of financing.

There are many ways in which grain firms can adapt:

- Grain firms need to expand working capital however possible to provide the base against which increased borrowing is possible.
- Understand and utilize nontraditional sources of financing — if possible and when appropriate — including basis “repo’s” or contracts that involve producer financial participation.
- Think cash flow. Reassess payment policies for farm grain. Most elevators will pay daily, but numerous destination markets pay only once or twice per week, forcing elevators to hold the receivable. Consider changing farmer payments to twice weekly, for example. But make such changes only after adequate notice to customers so the rumor mill doesn’t kick in that your firm is out of money.
- Think “risk management” rather than “hedging.” Understand and utilize — when appropriate — alternative ways to manage price or spread risk. This could involve greater use of options aside from the usual backing for Minimum Price Contracts or Maximum Price (“Cap”) Contracts. Know how to utilize short options as well as long options as a method to address risk positions. Understand what state dealer licensing laws require or prohibit, and know your bank covenants!
- New alliances are appearing: A grain firm and a bank, for example, may work together to offer a proprietary strategy. Or area elevators may cooperate to better utilize resources and minimize expenses.

- Reassess what it means to buy forward-grain: The idea that firms buy fixed price, fixed basis forward contracts and bear all the financing costs may become a thing of the past. The costs and risks are just too great for most firms to absorb.
- Reassess whether some producer contract strategies carry more risk than the contracts are worth to you as a buyer. Some of the more “exotic” strategies are not appropriate when there’s almost no way to measure potential price moves.
- Reassess what customer “service” means. More elevators won’t buy when futures markets are closed, for example. Refocus to address and identify other

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needs of your producer customers. Set policies that are realistic for this new environment: e.g., maximum accounts receivable for feed or fertilizer, maximum bushels on forward purchases from a single customer.



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- Think like a CFO, or if possible, hire a CFO. Accountants document what happened and account for it. CFOs analyze projected cash flows and consider numerous "what if" scenarios to determine the impact on the business.

Throwing out all your policies, procedures and strategies is overkill. But put everything on the table

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and rethink whether your current ways are the best or the only way to operate. Take forward purchases for example. Lenders, grain firms and others are reassessing

what makes sense. There's interest in making producers responsible for some percentage of any upward price movement that could trigger margin calls: The farmer might have to put up 25%, or 50%, of such margin calls for example. Other firms are trying to tie that right into production loans from the farmer's bank by negotiating: e.g., "We'll buy the 2009 grain from Mr. Farmer, but Mr. Farmer's bank has to agree to "finance" 50% of our margin calls on that contract. If forward-selling protects the farmer's bank, then perhaps they should help fund that protection.

Another idea tossed around is how to offer and manage forward HTAs. Traditional HTAs have allowed the farmer to pick the day to set the basis on the contract. An alternative might be for buyers to "aggregate" or "pool" harvest 2009 HTAs, for example, and leave the basis decision to the elevator manager for all the contracts, or use a predetermined formula that's consistent for all forward HTAs. Perhaps a Midwest elevator might

set all harvest 2009 corn HTAs using the basis on October 15. There's nothing special about October 15 — that's just for illustration.

Exotic strategies that can work well in flat markets can be killers in extremely volatile markets. Consider

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purchases that offer producers a small bonus on their selling price in return for the obligation to sell more

bushels if/when prices reach a certain threshold that's above current values. Those are fine until prices soar through the upper price level. A lot of farmers sold grain on contracts that obligated them to sell more grain for 07 crop if prices were to reach \$3, for example. Not such a good idea, in retrospect.

These are just a few ideas — the marketplace will find others and time will sort out the winners and losers. Customer service is still important, but survival is Job 1 in these new volatile times. ■



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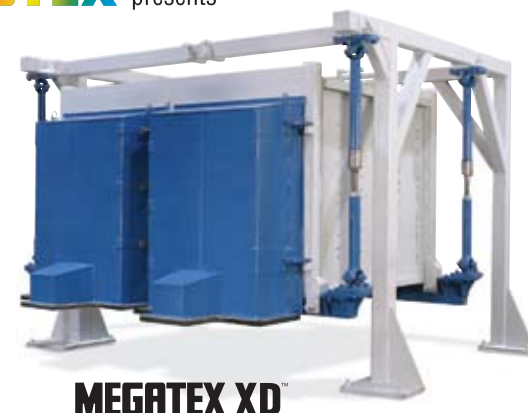
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