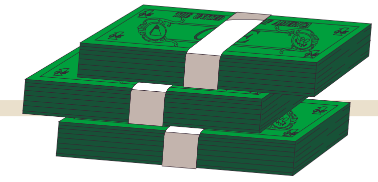
By Jeff Atkinson and Diana Klemme



Cash or Credit? Tipping the Odds in Your Favor

Managing credit risk deserves close attention, especially in this year's difficult environment

It's tough to make money in a crop year like 2002/03. Handling volumes were down sharply in many areas and net basis carries have been meager. Except for a short-term swing or two off transportation problems, carries have been flat to negative for soybeans. Elevators in some areas had a good fall, very good in some cases. But just about everyone has struggled since then. An unrewarding environment like this may not be much fun, but it's often when management — good or bad — makes the biggest difference. Less risk rather than more is usually advisable during difficult times. Managing credit risk is an area that always deserves close attention, especially this year.

The credit-risk environment seems to have worsened in our industry and in the economy at large. Margins in livestock and poultry feeding have not been good for some time and rumors swirl about potential failures. In some areas there are new end users or grain buyers whose financial staying power is unproven. The general economy isn't strong, and there's uncertainty aplenty with war looming and energy prices going through the roof. The three biggest bankruptcies in U.S. history have occurred in the last 15 months.

Elevator managers typically aren't too concerned about credit risk. Sudden failures are rare among grain merchants and users, after all. Many merchants and users are large, conservative companies that have been around for 50 years or more and have weathered many storms. You probably don't need to be as concerned about credit risk as managers in many other industries, but today's conditions still warrant attention.

Credit risk in our business tends to be concentrated. The typical elevator doesn't have significant credit exposure most of the time. But many elevators — especially large train shippers — have a lot of exposure to individual buyers for short periods. And those losses, when they occur, tend to be total losses.

General creditors seldom get much out of bankruptcies when a grain merchant or user fails. Most managers will make it through their entire careers without having a buyer declare bankruptcy. But if it happens, it can be devastating.

Your risk is a function of the probability of a loss. But it's also a function of your firm's financial strength and ability to suffer a loss without impacting future earnings. That's why it may not make sense for a smaller company to do what the big companies do. For example, consider a midsized country elevator shipping 75-car corn trains worth around $650,000 to any particular buyer (270,000 bushels at approximately $2.40 per bushel). Assume this buyer is privately owned and the elevator knows little about its financial strength. But several of the large grain companies ship trains to this company so the elevator manager figures it must be OK for them as well.

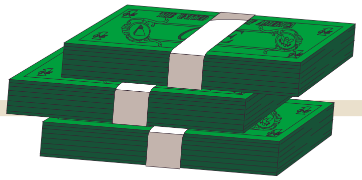
But a loss of $650,000 would do significant damage to the elevator's balance sheet. Coming out of current assets, that loss could cause the credit line to be reduced or pulled entirely. The business would have to seek an equity infusion or even be forced to liquidate. In that case, the "hit" to owners' wealth would be $650,000 plus the difference between the value of the business as a going concern (discounted present value of future earnings) and what it would bring in liquidation. In this scenario the effective credit risk might be $650,000 multiplied several times. You should have an idea of the point at which a credit loss would impact your company's future earning potential. Extending credit beyond that means "betting the company."

Most elevators have access to one or more very strong buyers. The credit-risk in selling to them is close to nil. In this case, credit-risk management is largely a matter of whether to sell to a strong buyer or to a more risky buyer who will pay more, betting that company won't go bankrupt while you're exposed. For example, say you ship $650,000 trains. You can sell to Buyer A, a rock-solid company, on "order bill, sight draft" terms at +15 basis. There's little credit risk in such sales. Or you can sell to Buyer B at a basis of +16. But that'll involve shipping "open" (unrestricted bill of lading) and carrying credit exposure for about 10 days. What do you do?

Imagine instead of running a grain elevator that you're an insurance underwriter accepting risks for a syndicate at Lloyds of London. A broker approaches you about writing $650,000 of insurance against Buyer B going bankrupt. The term is 10 days and the premium is $2,650 (1¢/bushel). How do you decide whether to accept the risk or not? First, you look at your capital position (balance sheet) and the policies you already have out. Are you capitalized to comfortably take on this risk? Then you consider whether the risk is attractive or not. Considering what you know (and more important, what you don't know) about Buyer B, is the premium enough? For this risk to be attractive, the probability of a loss must be less than 0.4%. That's one loss for every 250 times you write such a policy. It's a pretty high hurdle. For example, if you ship trains to this buyer five times a year, you must expect less than one loss every 50 years.

Figured another way, a loss of as little as $100,000 means the next 2 million bushels you handle at 5¢ margin goes strictly to offset the $100,000 write-off. And then you're left with zero net revenue after all that work. Maybe some elevators can survive that kind of event in the good years of big crops and wide carries; this year few probably can.

Evaluating these risks is more art



than arithmetic; there are no actuarial tables to quantify the probability of loss. Our sense is that some managers are too aggressive in accepting credit risk with buyers they really don't know much about. It may be better for your merchandising bottom line to take a slightly lower price or basis in exchange for less credit risk. A 1¢ lower basis on a 270,000-bushel train acts as a $2,700 form of "insurance" against financial failure.

Protecting yourself

Even dealing with firms you consider sound, there are other simple steps that can help reduce credit exposure. Typical rail contract terms call for payment within a few days of shipment. Sellers in rail markets can use Order Notify bills of lading with bank drafts for credit protection. (On an Order bill of lading, the railroad will not release the cars to the destination until the bank has assured payment.)

Truck elevators can scatter sales among several buyers to reduce exposure to any one firm. Insisting on wire transfers or picking up checks protects you further. At the least, watch for any change in payment pattern, and set a cap on your outstanding receivable from any buyer. These are basic management practices, but ones that firms often ignore in our low-margin industry where billions of bushels trade on phone calls and trust and an extra 1¢ is hard to turn down. ■

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