

By Diana Klemme

Money, Money, Money!



13 billion bushels of corn and the highest harvest price since 1997!

The highest wheat futures prices since 1996!

A smaller soybean crop this year, but \$9 futures!

The 2007 crop will be one for the books, and especially for the bankers. Combined stocks of 19.4 billion bushels of corn soybeans and wheat will likely, set a new U.S. record, *almost 1 billion bushels above the record set in 2005.*

Last harvest was a challenge at 17.8 billion bushels of September 1 stocks of wheat, corn and soybeans, plus production of corn and soybeans. But 2007 could add 1.5 billion bushels to that and further stress the grain industry on all fronts: handling and

2007 Crop Volume "What if?"			
(million bu)	Corn	Soybeans	Wheat
Sept 1 stocks est	1,000	600	1,900
Production est	13,200	2,650	
Total	14,200	3,250	1,900
Cumulative	19,350 (million bu)		

storage capacity, transportation, and financing. Corn and soybean production isn't known yet, but for financing that is almost

irrelevant: If yields are threatened in late summer, there's a good chance prices would raise further!

On paper there was sufficient space for the 2006 crops, but reality differed substantially as the countryside of the Midwest was blanketed with piles totaling hundreds of millions of bushels of corn. USDA's December 2006 estimate of available U.S. grain storage space is 20.4 billion bushels. Nationwide that includes 11.6 billion bushels of on-farm capacity and 8.8 billion bushels of commercial space, and also used to warehouse grain sorghum, oats, barley, sunflowers, minor oilseeds, and pulse crops. Space available for the "Big 3" — corn, soybeans and wheat — is reduced by inventories of those other crops, but offset by grain storage capacity gained with the opening of numerous ethanol facilities.

(USDA states that on-farm space includes bins, cribs and sheds normally used to store whole grains and oilseeds. Off-farm space includes elevators, terminals, processing plants, but excludes "ground-storage" capacity as well as facilities that store only rice or peanuts and certain other limited-use entities.)

Farmers and elevators are expanding storage capacity this summer but that is unlikely to solve the space problem this fall. In the past five years warehouses and producers have added 750 million bushels of capacity; this year the industry needs another 1.5 billion bushels. Producers may utilize sheds, pole barns and maybe even the family's dog

house to tuck grain away, and it still won't be enough! There'll be grain everywhere, with the resulting backlogs on railcars, high barge freight and cheap basis. Elevators will likely face delays in shipping a lot of grain even after they sell it and that hits on the next problem.

Money is now a bigger limiting factor than warehouse space for many firms in the grain industry. The explosive growth in U.S. corn demand and declining global coarse grain and wheat stocks have sent futures soaring. Prices may back off some, but few traders seriously expect a retreat anytime soon to the lows of 2006.

This table simplifies the financial picture but it conveys the underlying message:

Higher prices x higher production = **higher purchase costs!**

In the real world, farmers don't sell all their grain at harvest, and elevators ship throughout the crop year. But higher prices encourage heavy farm selling, and cheap basis at harvest encourages elevators to hedge and hold. Big crops can also make it tough to keep grain moving to keep cash flowing in. Producers have also been forward-selling 08 and even 09 crop anticipated production to protect these high prices, adding to margin call uncertainty for elevators and terminals.

Money!

Funds for elevators to buy and hold grain typically come from a combination of the business's working capital and borrowed funds. But every firm has an effective limit to their borrowing capacity, and expanding credit lines with

banks can take time (especially as the lines get larger).

Money, money!

Elevators can expand and manage their financing capacity by sell-

ing grain in-store with the buyer agreeing to prepay against warehouse receipts (WHRs). This has some advantages for the seller if that buyer is the usual market and if the sale basis and time captures

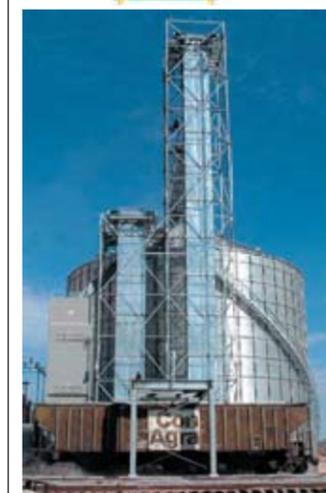


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	2006			2007		
	Production	X Price*	= \$ (bln)	Production	X Price **	= \$ (bln)
Corn	10,534	\$2.54	\$26.8	13,200	\$3.10	\$40.9
Soybeans	3,188	\$5.52	\$17.6	2,700	\$8.50	\$23.0
Wheat	1,812	\$3.90	\$7.1	2,000	\$5.40	\$10.8
Total	15,534		\$51.5	17,900		\$74.7

*USDA average farm price, October 2006 (July 06 for wheat)
 ** Estimated farm prices for 2007 harvest use new-crop futures prices as of July added to harvest basis. 2007 production figures are estimates using USDA acreage and potential yields

good merchandising returns. This accomplishes two objectives: freeing up funds and reducing merchandising risk exposure.

Money, money, really big money!

Another approach is an innovative arrangement known as a Repurchase Agreement ("Repo" or "Repos"). This will involve a large entity with sizable available funds, typically a financial firm looking for

investments, rather than a bank or grain company. Let's call the entity "Big Money."

In a repo, the buyer agrees to take title to and pay 100% for your grain in-store, backed by WHRs issued to the buyer. The buyer agrees to price the grain immediately by exchanging futures with the elevator/seller. This eliminates the elevator/seller having funds tied up in Initial Margin requirements for hedges, and eliminates the risk of further margin calls.

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The second part of the initial repo transaction, is that the buyer (Big Money) simultaneously contracts to sell the grain back to the storing elevator at a known basis at a defined point in the

future. Repos could be for any time period, but are often for multiple months. When the end time nears, the elevator is required to buy the grain back at the forward basis agreed on

when the repo was done. The "repurchase" would be priced by a second exchange of futures, or by the buyer/elevator selling futures after which the elevator will pay Big Money the contract value and receive the canceled WHRs.

The cost of money for the elevator is an implied "interest rate" equal to the difference in the two basis values and which is competitive with existing bank lending rates.

Example of Repurchase terms (purchase and sale done simultaneously):

Sell grain to "Big Money" in October at — 60 July 8 corn futures — to be priced in October;

Buy back from Big Money on April 15 at — 48 July 8 corn futures to be priced on April 15

Inferred "cost" is 12 cents basis "loss" for six months

Repos offer distinct benefits for elevator (sellers).

- Eliminates all risk of margin calls and wire transfer fees during the repo period.
- Frees up working capital for the elevator.
- Can improve balance sheet liquidity ratios (check with your accountant).
- Is not viewed by bank lenders as a competing loan.
- Repos don't replace a borrower's bank credit line, they expand borrowers' overall financial capacity.
- Both buy and sell basis are negotiated and accepted upfront; the elevator's cost is transparent and easily calculated.
- The repo period is mutually

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agreed on — no surprises or unilateral changes.

- Elevators can structure the repo for a time when borrowing needs are typically high, with the “buy back” date set to coincide with probable lower financing requirements.
- Allows the elevator to merchandise the grain at any time for sale to any cash market as long as delivery will not occur until after the end of the Repo when title is reclaimed.

Repos can provide significant merchandising flexibility without tying up valuable elevator working capital. They leave more room

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— Diana Klemme,
Grain Service Corporation

or capacity on an elevator’s bank credit lines to handle buying and holding short-term positions, or to

finance hedges for other grains or future crop year purchases. A repo on 500,000 bushels of soybeans, for example, could free up around \$4.5 million of credit or working capital.

What’s in it for big money?

Huge pools of money are available around the financial world these days, looking for homes with varying risk and return. An inferred cost to an elevator of 7 ½ to 8% under a Repurchase Agreement is also a return to a financial entity of 7 ½ to 8%, quite a reasonable return for a clean, low-risk transaction.

Repos also provide “Big Money” firms another way to expand their presence in agriculture — an area of interest to investment capital in this era of commodities. Repos may lead financial entities to expand into purchase/lease-back arrangements on grain facilities, or even the outright purchase of ethanol plants, elevators or other handling operations.

The grain industry needs staggering sums of money to buy and carry the 2007 crop and carry hedges on purchases for subsequent crops. Financial firms can also structure innovative hedge financing strategies to remove

the burden of unquantifiable margin calls on future crop-year contracts for elevators, but these arrangements are more involved than straightforward Repurchase Agreements. (There’s no way to issue WHRs on forward contracts; different protection has to be structured for the financial entity.)

Large financial entities have plenty of money they can put to work without the bank regulatory structure. Sounds like a good marriage that works for both sides! But whether you finance your business using conventional bank credit lines, sell in-store to usual buyers, or use innovative financing, plan

ahead of the market. You don’t want to be caught with insufficient working capital or credit lines in a roaring bull market.

Call Grain Service in Atlanta to find out more about Repurchase Agreements and how they can expand your business’s ability to operate in highly volatile, high-price markets. ■



Diana Klemme is a longtime contributor to FEED & GRAIN. Contact her at Grain Service Corporation, Atlanta, GA, by calling (800) 845-7103 or e-mail at diana@grainservice.com.

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