When $7 = $4.80

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By Diana Klemme

*"You mean to tell me that with corn futures at $7, I can't sell you the bushels today because I **might** have to sell them to you months from now at $4.80? What kind of a deal did you get me into, anyway?"*

Imagine a producer sitting in your office during the height of a bull market, demanding an answer to *that* question. Most managers would rather be outside loading a train in January than face that farmer. Now think about the grain marketing strategies you offer your producer customers, and why you offer those strategies. Do they expose your business to hidden risks?

Originating grain is always a challenge. You have competing interests: Your business has to make money and you need volume at a good operating margin to accomplish that. But customer satisfaction is also a priority. When you're wearing your "farm advisor" hat, customers often want a higher price, or want the flexibility to capture a higher price if futures move higher. Other customers want to sell grain to you, but want you to offer the same strategies 'the other guy' offers, or something they heard about at an advisory meeting. Elevator managers can be unsure which hat to wear.

Define objectives and parameters for your origination program:

- Is volume more important than the margin on your purchases, or the quality of those purchases? Identify which crop years you will allow farmers to sell for.
- Set a maximum percentage of production you will allow a farmer to contract with you.

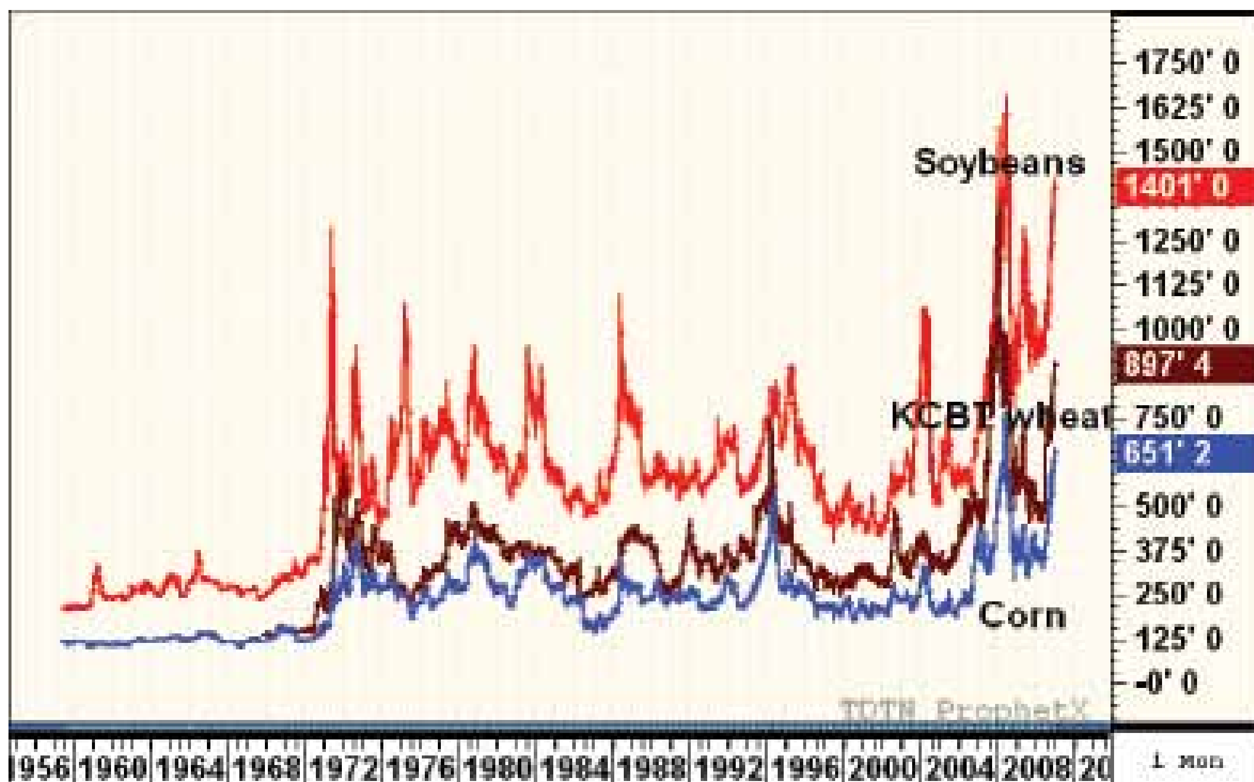

Chart: Weekly Continuation chart of CBOT futures

- Identify how you will decide which farmers will be allowed to use more sophisticated strategies.
- List the variables of a farm-marketing strategy and the strategies that go along with that profile. For example:
    - futures price not finalized
    - basis not finalized
    - sets a futures floor but not a ceiling
    - sets a futures floor and a ceiling but leaves open a "window" of price opportunity
    - pays the farmer a premium for his/her grain but with an obligation to sell additional bushels if futures are at or above a specific level at a future point in time.
- Quantify the potential risks of each strategy in various market scenarios, both to your business and to your producer-customer.
- Next, identify which strategies you will offer, and ones you will not offer.
- Review your advertising and promotional materials for *all* strategies to see it's clear and not misleading.
- Determine who within your organization is sufficiently trained and knowledgeable enough to buy grain using the more-advanced strategies.

Country elevators aren't grain companies

Let's face it — elevators just don't have the same resources that large companies have. Their balance sheets and credit lines are a fraction of a grain company's. Elevators don't have a legal staff, or sophisticated market-modeling software to analyze risks and outcomes. Elevators don't typically have a separate staff to manage producer marketing programs. That's not a problem unless you're trying to compete on the same playing field. Further, an elevator's accounting staff may not recognize how to properly "mark to market" advanced contracts to ensure accurate financial reports.

Global grain(s) consumption continues its upward trend despite rising prices. The crop losses in 2010 brought to the forefront again how tight global inventories are and the potential consequences of widespread production failure. High prices do come and go, and it's possible prices will retreat in 2011 if global production

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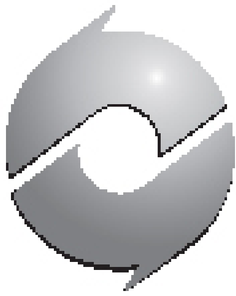

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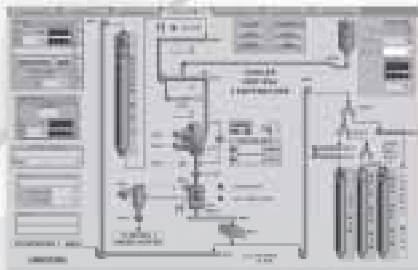

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soars. But ag commodity prices currently reflect the ongoing concerns.

High prices = higher risks

High prices and volatile markets can pose unusual risks for country elevators and small grain businesses. High prices mean your working capital and credit line won't go as far, for example:

	At a corn price of:	Buys this volume:
$1 million	$3 per bushel	333,333 bushels
	$5	200,000 bushels
	$7	142,857 bushels

Rising prices mean margin calls on short futures hedges. Some credit lines are structured so that the bank will only finance part of the margin calls on forward contracts, forcing the elevator to finance the rest from working capital. Counterparty contract risk on forward purchases rises with the market. A farmer who was thrilled to sell $4 corn for 2011 crop may be less than eager to deliver the corn if prices rise to $7.

Beware the hidden risks!

Margin call risk can be sizable, but at least it's easy to identify and quantify. Beware of the hidden risks of some contract strategies involving options that can explode suddenly into serious losses during big market swings (up or down):

1. **"Reduced-cost" minimum price contracts**
   a. farmer sells priced grain to the elevator
   b. the elevator offers upside price potential by buying one or more call options and tying the subsequent value of the options to the contract
   c. *the elevator sells out of the money put options and collects a premium which is used to reduce the cost of the call(s).*
2. **"Ratio" minimum price contracts**
   a. farmer sells priced grain to the elevator
   b. the elevator offers upside price potential by buying one or more call options and tying the value of the options to the contract
   c. *the elevator sells higher Strike Price call options at a ratio of 2:1 or more, and collects multiple premiums which are used to reduce the cost of the call options* that were purchased in (b).
3. **Premium-Offer contracts (or similar names)**
   a. farmer sells priced grain to the elevator
   b. the elevator sells one or more call options at Strike Prices above the market and credits the premium collected over to the farmer,
   c. and requires the producer to *sell more bushels to the elevator if the designated futures contract price is at or above the Strike Price on a specified date.*

Each strategy has special risks in certain market conditions. In #1, the risks develop if futures fall hard

and the short put options are exercised. That leaves the elevator long futures with nothing to offset them unless the contract clearly states the farmer would be responsible for such losses.

In #2, the risk lies in rising prices. As futures climb, the elevator is losing money on two (or more) short call options while making money on only one (the lower Strike Price). The higher futures rise the worse the outcome. Again, unless the contract clearly states the farmer would be responsible for such losses, the elevator will have a major problem on its hands. There is also the problem that although a futures rise will 'hurt' the position, the final outcome can't be identified until either option expiration or until the option positions are exited.

In #3, the farmer faces an even bigger uncertainty. This strategy creates a binding obligation that the farmer will sell additional bushels to the elevator, but contingent only if futures are above a specific price *on a specific date*. There will be no additional obligation to the farmer if futures are below the designated threshold on the specified date. The benefit for the farmer of this strategy is that he or she collected some premium/incentive at the time of the original contract — a "signing bonus," as it were.

Strategies 2 and 3 can be major problems in bull markets such as 2010/2011. The farmer starts off at what is an attractive selling price and gets a "bonus" premium added on top of the price! Example:

July 2010: Dec 2011 corn futures around $4.40
Dec 2011 $4.80 corn calls were trading around 30¢/bushel

Farmer forward contract would be $4.40 + basis + 30¢ premium.

Farmer takes on an obligation to sell additional bushels at $4.80 corn futures
if Dec 2011 futures are above $4.80 on a designated date (e.g. Oct. 15)

January 2011: December 2011 corn futures have climbed to $5.90
Dec 2011 $4.80 corn calls are now at $1.35

The elevator has had to finance margin calls on the short futures hedge since July 2010, and also margin

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the growing loss on the short $4.80 corn calls. The farmer still has the original sale for 2011 crop at $4.40 futures (+ basis) + 30¢, now $1.50 below the market, *and also has an ongoing obligation to sell more bushels to the elevator at $4.80 futures (+ basis) for 2011 crop delivery if futures remain above $4.80 at the designated date*. Farmers won't be happy about this.

And worse, it ties the farmer's hands if he (or she) wants to sell more corn for 2011 crop at $5.90 futures but has this additional potential sale obligation. Assume corn continues to $7, or even $8 this spring or summer. The farmer can't sell with confidence due to the ongoing obligation that won't come due until this fall for additional bushels. What a marketing nightmare!

Elevators also have to properly mark such contracts to market each month on their financials. The brokerage monthly statement will show the rising loss on the short call option, but some elevators may fail to include the farmer contract side. This would create an imbalance, *against the elevator.*

This can also be a customer public relations nightmare, especially if the farmer wasn't clear in the beginning just how the contract works, or if the elevator employee downplayed the risks: (*"oh come on, Joe, corn's not going to $6.00 and you get a 30¢ bonus on your deal")*.

Proponents will say that a premium offer deal is no different than with a farmer who forward sold corn when futures were $4.40 and they're now at $5.90. But it is different: The premium offer contract ties the farmer's hands and forces him or her to pass on other marketing opportunities for that second unit of bushels. If futures end up above $4.80 he'll be unhappy he has to sell at $4.80 (+ basis); if they're below $4.80 he'll be furious he had to turn down higher prices while waiting to determine the outcome of the outstanding $4.80 "offer."

My rule of thumb when managers ask about this strategy is to ask both the manager *and the farmer* if each can tell me exactly what the final contract price and bushel obligation will be in any market price scenario: at $6, $7, $10 and at any point in time. If they can't do so (and often they cannot), then it's best to put "Premium offer" or similar complex strategies back on the shelf and stay with the basics.

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