By Diana Klemme & Jeff Atkinson

Risk²? The Year Ahead

There's no single explanation for the dilemma of a mediocre profit/loss statement — and there are no easy solutions.

Mike stares at the financial report then tosses it on his desk, wondering what to say at next Monday's board meeting. The directors didn't seem pleased with the harvest merchandising results — especially on soybeans — and there's little improvement in the December numbers. "I sure thought we'd do well this fall," he sighs to himself. "We stayed open long hours, handled more corn than ever, captured some new customers, sold basis at high numbers, and we still didn't net much on corn or soybeans."

Pulling his Daily Position Report off the shelf, he skims over it, hoping to spot positive things he can focus on at the meeting. "Well, we're long the basis on a lot of corn, and that seems to be working. I have some forward sales in place for Jan/Feb/March so I don't have to rely on the spot basis, but we own enough that I can easily sell for quick shipment when things heat up." Flipping to the soybean section, he notes the sizable Delayed Price (DP) position: "Hmmm, we're long basis about two trains' worth, with another 200,000 bushels of DP ownership. I need to get rid of the basis ownership and start getting short DP. Nothing to be gained owning basis in a big inverse!"

He jots down some points he wants to cover with the board:

- Large harvest volume, new customers, good reports about service and unloading
- Railroad performance was poor this harvest — cost us some money on late shipments
- Difficult year for soybean merchandising: Big inverses, higher and volatile prices, free DP everywhere — hard to make money. Would anybody else do better?
- Unusual basis moves
- Corn — the forward sales give me flexibility. Long basis position earns a return for elevator space.
- Financing demands for inventory and hedging have been unusually large.

Pausing, he decides these points don't sound very positive and wonders if the board will think it's time to look for another manager. "But this is an unusual year," he reassures himself. "Or is it? What if markets don't settle down and carries don't return? Just how much risk could we face?"

Start with the basics

Mike faces a common scenario: a mediocre P/L from a grain facility that seems to be doing things correctly. There's no single explanation for the dilemma and no easy solutions. Grain handling is a mature industry, and margins tend to be small in mature industries. That leaves little room for big mistakes. One elevator's #2 yellow corn or #1 soybeans are pretty much like every other elevator's inventory. Storage and drying are generic services; farmers pay only for the result, not for the quality of the services. Handling margins at grain facilities seem to be little better than they were 30 years ago! Elevators can speed up their truck

U.S. Corn and Soybean Supply/Demand Scenarios

	2003	2003	2004	2004	2004	2004
	Corn	Soybeans	Corn	Corn	Soybeans	Soybeans
Pltd Acres	79066	73585	79500	79500	74300	74300
Yield	143.2	33.8	134	143	34	40
Product	10278	2452	9700	10350	2490	2930
Use	10025	2505	10000	10200	2490	2850
End stocks	1349	125	1049	1499	125	205

Yields and usage for 2004 crop are scenarios, not predictions. 2003 numbers are from the USDA November 2003 Supply/Demand report.

dumps and improve their customer service, but those aren't real innovations and customers won't pay for them.

Managers who want to increase profits often focus first on increasing harvest throughput or on building storage space. One intriguing question is whether country elevators make much money on the extra bushels they put through and ship during good harvests, or whether the major benefit to the bottom line comes from better carries on bushels they put away. Managers seem divided on this. Some say they make good money, but others feel that it's an "activity trap." These managers say that after paying overtime and other variable costs, harvest handling margins aren't good enough to make much money. There also seem to be significant differences in managers' perceptions of what certain handling margins do for their bottom lines. Some are pleased to handle soybeans for 10¢ for example, while others say 10¢ barely covers their costs. The question of costs is important. You can't make informed decisions about setting bids and margins without a good feel for your marginal costs. And you can't evaluate alternative investments without cost information. Should you invest in load-out and transportation capacity to increase harvest capacity, or should you invest in storage to allow you to hold those bushels for basis appreciation or storage revenue?

Marginal costs are changes in variable costs associated with handling a few more or less bushels at various levels of activity. Conventional theory is that marginal cost per unit increases as volume increases, often in a series of steps as capacity limits are reached. The biggest variable cost for grain elevators is labor, with "wear and tear" on equipment probably next biggest. Useful guidelines comparing such harvest-time costs don't seem to exist; most studies focus on annual costs.

Mike should analyze expenses and determine his elevator's true cost of handling grain. Only then can he tell whether his bid margins are sufficient. He also needs to seriously consider if he can increase his bid margin. Competing for volume on which he'll lose money if he has to ship it right away is wasted effort. Upgrading for faster throughput is also wasted if the harvest margins aren't there.

Wilder times ahead?

Even after Mike analyzes his costs and margins, Mike faces other risks that can jeopardize profits. And he can't count on the volatility of 2003 and its associated risks going away. World grain inventories have been declining for years, falling in 2004 to the lowest levels in 30 years. World coarse grain ending stocks are now down to 11.7%, just 42 days of usage. Chinese officials are already making public comments about a policy shift to restoring food security and away from exporting. The United States is the world's largest exporter of coarse grains, and other countries will turn to the U.S. to meet demand when China cannot.

World soybean demand is rising 5% or more annually, but U.S. soybean production has stayed relatively flat for years. That means the world depends on Brazil and

Argentina to expand their production sufficiently to meet that demand. So far they have, and world soybean carryovers are adequate. But the crop year differential between the Northern and Southern hemispheres poses a big challenge. Shortfalls in U.S. production — such as in 2003 — can create dramatic but temporary disruptions until South America's harvest begins six months later.

Corn and soybean carryovers here in the U.S. warrant close attention. U.S. corn and soybean acres combined have been flat for seven years (152.6 MM in 2003). Corn acres tend to stay around 51% to 53% of the total, with soybeans accounting for about 47% to 49% of acres. A lot of Western Corn Belt farmers are disillusioned with soybeans after the insect and disease problems of the past two years, but high prices should still encourage slightly higher acres for 2004.

What's apparent is that unless soybean acres and yields both rise, the U.S. could face extremely tight soybean supplies through 2005 or beyond. Even corn ending stocks could fall if U.S. exports rise to offset declining Chinese exports and usage for rising U.S. ethanol production.

Elevator margins have long been notoriously small, but recognize that it costs money to handle grain. Some of the costs of handling grain rises with higher futures (shrink, interest cost, etc.), but margins are stagnant. Consider widening margins at the expense of some marginal bushels.

Review your company's credit policies regarding farmers and commercial buyers. Know who you're dealing with!

This is the time to secure secondary lines of credit that you can tap into on short notice. Banks typically require a fixed fee for such lines as they often remain unused, and elevators have been reluctant to pay for the security. Managers trust their lender will be there for them. That trust could prove expensive if your borrowing needs explode with the markets. Review "worst-case" borrowing scenarios with your banker, because they don't like surprises.

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> Diana Klemme,
> Grain Service Corp.

Risks can multiply

Merchandisers already face substantial risks this year. Soybean futures spreads have been volatile and often steeply inverted; holding owned inventory very long can be a high-risk position. Soaring futures have already strained the ability of many grain facilities to meet margin calls on hedges and inventory financing needs. Volatile futures also increase the price risk a merchandiser faces between time of purchase and time of (cash) sale or futures hedge. Contract risk rises in volatile markets, and credit risk soars. Managers need to decide how much total risk their business can handle. It may mean limiting basis ownership, being more conservative on spreads, or just generally being more diligent about jumping on potential problems.

The risks merchandisers face this year may multiply and may last until 2005 or beyond. One major task of futures this year is to encourage sufficient acreage for the 2004 crop, and to discourage demand through higher prices when necessary. There is even the potential for explosive markets ahead if South America's 2003 crops falter this winter, or if either 2004 (world) crop acreage or yield potential looks inadequate. Only great crops can calm the markets more than temporarily. The six-year cumulative world soybean production surplus vs. usage ('98 through '03 crops) amounts to just 3% of annual usage — a marginal cushion at best. World coarse grain demand has exceeded 900 million tonnes annually since 2000, but production only reached 900 million tonnes once, in 1996 after U.S. corn futures had soared to $5/bushel. These production shortfalls didn't impact markets much when there were surpluses to cover the deficits. But the 11th hour is here and markets are on alert. ■

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