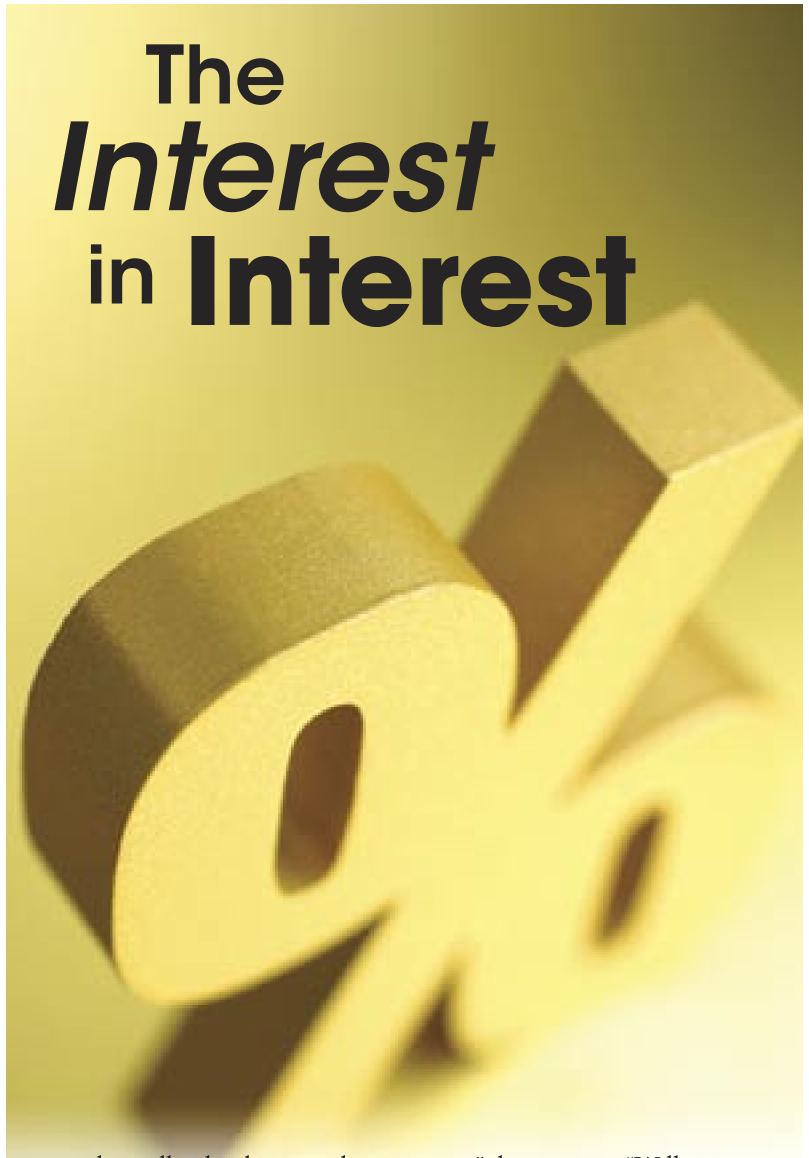
By Diana Klemme

The *Interest* in Interest



Mike walks slowly around the empty boardroom, making sure everything is ready for the meeting with the bankers later this afternoon. "Just my luck," he thinks. "Corn jumped another 8 cents today, the basis slid 4 cents at Easy Ethanol, and the ice storm has all our trucks sitting idle. I can't even deliver soybeans on our sales to get some money back in. And I bet our margin call will be $175,000 tomorrow morning. That's $45 per day just for the interest on this one day's call! $4 corn", he mutters. "Will it never end?" He arranges the papers on the table, glances out the window at the ice hanging from the gutters and power lines, and walks slowly toward his office. "I sure hope we can secure this additional credit line. I don't know what we'll do if they say no."

Everyone knows interest rates and prices are higher this year and credit demands are huge; but it's easy to underestimate the cumulative financial impact on your business. The extra expense for interest this year vs. last year will be more than a lot of country elevators earned in net profits last year. That's a tough hurdle to jump. Holding company-owned inventory is the biggest interest expense for elevators, but this year borrowing for margin calls will be close behind. Chart #1 shows prime rate, which has doubled in two years from 4% to 8.3%. Elevator borrowing rates vary of course, but Mike's facility borrows at 1% over prime. The blue line shows the elevator's monthly interest cost per bushel, using nearby corn futures and 1% over prime.

Mike glances at the chart he prepared. His elevator's cost has climbed from 1¼ cents/month to 2½ cents/month to hold hedged corn inventory. In October he hadn't thought that was a big deal. "An extra 1cent per month isn't much; I'll get that back easy." But consider the total interest cost if Mike's elevator holds 1 million bushels of hedged corn for three months:

Last year: 3 mo X 1 ¼¢ X 1 million = $37,500
This year: 3 mo X 2 ½¢ X 1 million = $75,000

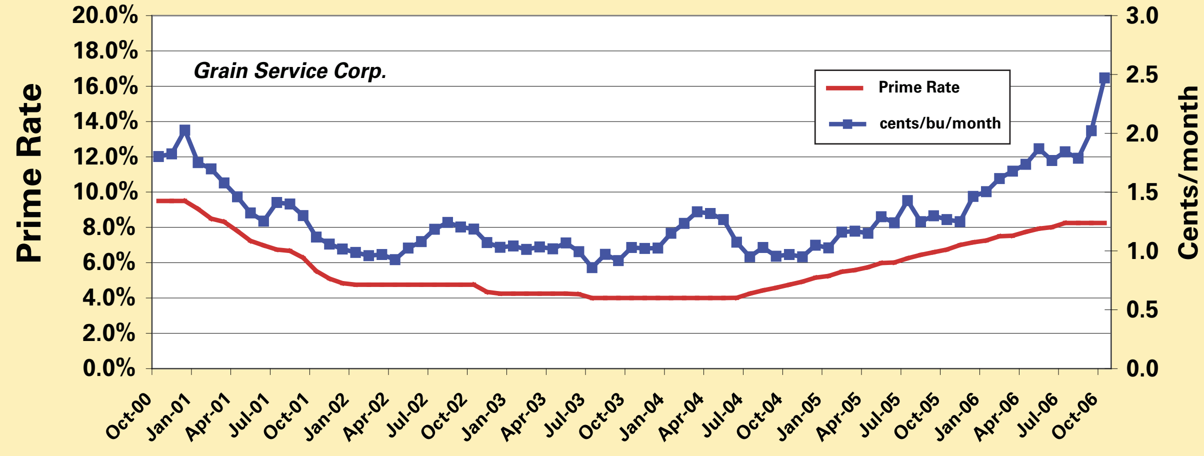
That 1.2 cents/bushel difference on corn now seems like a steep mountain to climb.

Interest cost/ month	Oct/ Nov 05	Nov 06
Corn	1.3¢/mo	2.5¢
Soybeans	3.8¢	5.2¢
Soft red wheat	2.3¢	3.9¢

Holding 1 million bushels of corn for six months will cost Mike around $150,000 this year in interest vs. $78,000 last year. Holding

Chart 2

Cost of Carry: CORN
(Prime Rate + 1%) X nearby futures



Oct 2000 thru Oct 2006

Monthly average prime rate, source: Federal Reserve

300,000 bushels of soybeans for three months will cost $52,000 in interest vs. $38,000 last year. Interest cost is like an elevator leg, a necessary tool of the trade. This year interest will be a very costly tool, and it's critical to recognize that the same basis gains or futures carries that compensated elevators last year don't stretch as far this year.

Mike leans back in his chair and listens to Joe, his scaleman, talking markets with a customer. "Widening 'back to back' margins is probably a good way to help offset our higher interest costs," he thinks. "I need to change that bid board before we buy any more grain."

Then there's the cost of financing margin calls. Mike has seen steady farmer forward-contracting since spring of 2006 for 2007 crop, as well as everything he bought for the 2006 harvest, and he's even bought a little 2008 crop wheat. December 07 corn is already 50 cents higher than Mike's average hedge level, and July 07 CBT wheat is up approximately 50 cents as well. But futures flattened out or declined a little this summer, so the elevator probably has funded margin calls for an average of 50 cents for only three months on those forward purchases. Assuming futures remain at current levels for another 10 months without rallying further, and interest rates don't change, Mike's interest cost on his 2007 crop hedges will be significant before the grain is even harvested:

50¢ X 9.3% X 13 months = 5¢ cost/bu.

And as an added cost, CBOT initial margins are much higher this year, 17 cents per bushel right now on corn. That money can be held in Treasury bills, but T-bills pay around 4% less than a typical elevator's borrowing rate. "Borrowing money is a cash-flow issue," he thinks to himself; "but the interest on carrying these forward hedges is an expense that can consume our 'back to back' margin."

Operating margins on forward purchases need to be high enough to recover this year's high interest cost on top of all other expenses. He knows that some elevators charge producers a service fee for handling forward contracts, but he's been reluctant to do so yet. "That might change after today's meeting," he chuckled.

Mike checks today's futures spread quotes. The carries beyond harvest 2007 are stingy: Dec7/March8 corn is at just a 5 cents carry, Nov7/July8 soybeans at just 7 cents carry. If the bull market continues, those carries could narrow further.

"There's no assurance at this point that I can recover our pre-harvest interest costs on all that 2007 crop corn we've bought and

Scenario: 12-month interest cost projection

		Corn	Soybns	SRW
Inventory *	1,000,000 bu @ 2.5¢/mo @ 6 mo.	$150,000		
	300,000 bu @ 2.5¢/mo @ 3 mo	$22,500		
	250,000 bu @ 5.2¢/mo @ 4 mo.		$52,000	
	150,000 bu @ 3.9¢/mo @ 3 mo.			$17,550
Hedge margins ** On 07 purchases	1,500,000 bu @ 50¢ for 10 mo (c/b/w cumulative)	$17,500	$8,800	$8,800
	Subtotal by commodity	**$190,000**	**$60,800**	**$26,350**
	Total			**$297,150**

*Owned/hedged; at present values; assumes prime rate +1% (PR source: Federal Reserve)

** assumes futures average 50¢ higher than elevator's hedge price. The hedge margin cost assumes holding wheat hedges until July/August; holding corn and soybean hedges for 12 months.

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hedged, even through smart basis/spread trading."

Mike enters a few numbers in his computer just to prepare a little more for the meeting with the bankers. He has a merchandising plan but he wants to know the price tag. Mike also senses a couple of buyers are starting to slow down their payments by just a day or two, which also adds to his interest expense. He doesn't add that to the spreadsheet but will mention it in the meeting.

"How am I going to recover all these interest costs? But if I widen my margin much more, the board will demand an explanation. And I've heard talk that some bankers are getting tougher on credit lines relative to capital. What if they turn us down?"

Just then there's a knock on his door and Sandy alerts him the bankers are in the boardroom.

"Good to see you, Jim, Terry. Might as well get right to business so you can get on the road before dark. Looks like it's time to request another increase on our credit line. I have a few numbers to update for you . . ."

Recap

The example used here is for Mike's medium-size grain operation, and even without including short-term day to day interest costs, his elevator's crop year interest expense could run to $300,000 or more! One mistake this year will be to only plan for the interest cost of owning inventory and overlooking the expense of financing the hedges on the inventory, and on forward purchases where you may carry hedges and contract risk for 18 months or more. Interest costs are real dollars right off the bottom line — how well would your operation's P&L withstand Mike's expense?