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Understanding the Drivers of Oportunity

Dear Ag Industry Associate,

Our latest issue of *Margin Manager* explores the historically strong profit margins that currently exist for hog and dairy producers. Due to the expanding impact of PEDv, record profitability is currently projected in Q2 and Q3 for hog producers. Meanwhile, spot dairy profitability has matched the record second quarter of 2004 following a new high for profit margins in Q1. The *Margin Watch* reports go into detail describing the drivers of these tremendous opportunities for both industries. Also check out the current projected profit margins for the beef cattle industry and crop producers.

Our contributing editor, Mike Liautaud, discusses objectively evaluating margin opportunities within a historical context, and how this can provide direction to strategically managing forward profitability. You will also gain insight by reading excerpts from an interview with hog producers Bob and Joe Dykhuis, who describe how the margin management approach has helped them secure profitability on their farm.

Leveraging 15 Years of Experience

Through feedback from our educational seminars, interviews and testimonials, we have received a wealth of information on how the margin approach has changed people's thinking and perception of risk.

We want to share these insights with you so that you may better understand what margin management is, how it works and what it allows people to do. In addition, you will find educational topics that highlight specific focal points of the margin management process, as well as articles that share specific stories about margin management in action.

It is our hope that you will come away with a deeper appreciation for why we are passionate about this approach to managing risk, and how it can benefit you and your business.

Sincerely

Chip Whalen

Managing Editor, Chip Whalen is the Vice President of Education and Research for CIH, a leader in Margin Management. Over the past 15 years, Mr. Whalen has lectured extensively throughout the country, introducing agricultural lenders, producers and industry associates to the margin approach to risk management. He has also written articles for many leading agricultural publications.

How do you evaluate a forward profit margin?

Evaluating a Forward Profit Margin

Building an accurate representation of your operation accounting for all costs and revenues is the first step in being able to estimate future profitability. Given that futures contracts are an unbiased estimator of what a specific commodity's value is expected to be in a forward time period, a producer could use the forward futures price as a placeholder to represent a future cost or revenue. Certain inputs would need to be taken as fixed estimated values if no correlation exists between those cash prices and futures prices. From there, along with other estimations for operational costs and basis values, a forward profit margin can be discovered.

Once an accurate model of your operation is built, the next step would be to evaluate the forward profit margin represented, starting simply with whether the projected margin is a profit or a loss. If the forward margin is projecting a loss, not much can be done to secure a profit unless the margin improves. If, on the other hand, the forward margin is projecting a profit, the producer would want to know how good of an opportunity that profit margin represents. One way to objectively determine the opportunity is to rank the projected margin over a historical period comparing that profit margin to previous profit margin opportunities.

Historical Measure

Let's say for discussion purposes that a dairy producer is projecting a profit for 2Q 2015 of $1.30 per hundredweight today. While showing a positive value for a forward production period is a good thing, the question this particular dairy producer should ask is, how good is this margin historically and ultimately is this opportunity worth protecting?

> "If you can determine that there is a strong correlation for prices you pay and receive in your local market to futures prices on the exchange, then the futures market can be used to model your revenues and expenses."

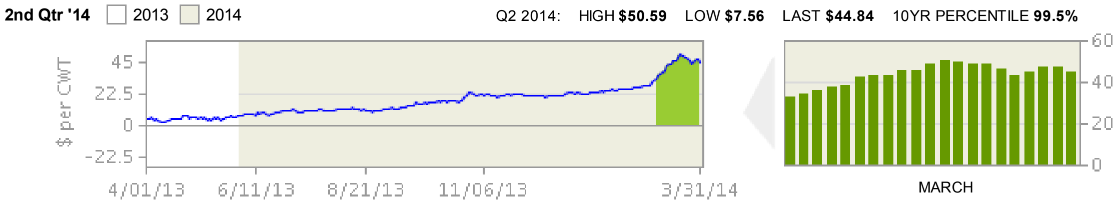
Keeping the model for this dairy producer constant, i.e. production performance, ration, basis values for inputs and revenues, etc. how would this dairy have performed in previous second quarters throughout history? We can determine the historical performance of the second quarter for this particular dairy by taking historical futures prices that would represent input costs as well as the futures prices that would represent revenues for previous years and attributing the values to the present ration and output performance thus generating historical margins. In doing this, we can compute an apples-to-apples comparison of the current opportunity.

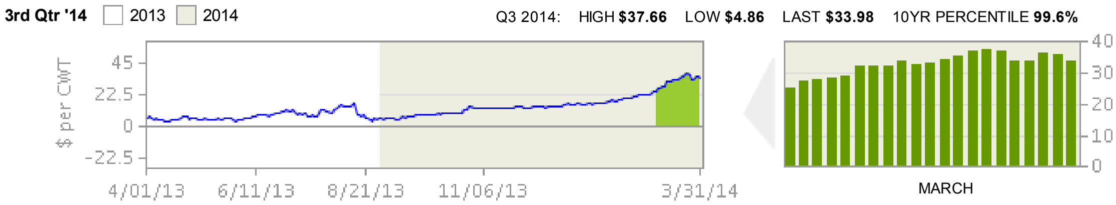
After generating the historical margin opportunities, the producer can then rank how the present $1.30 per hundredweight margin stacks up against history. For this producer, the current profit margin may rank in the 90th percentile of the previous ten years. In other words, given the same operation over the past ten years in the second quarter, this operation would have had a better margin opportunity 10% of the time while having a weaker margin opportunity 90% of the time.

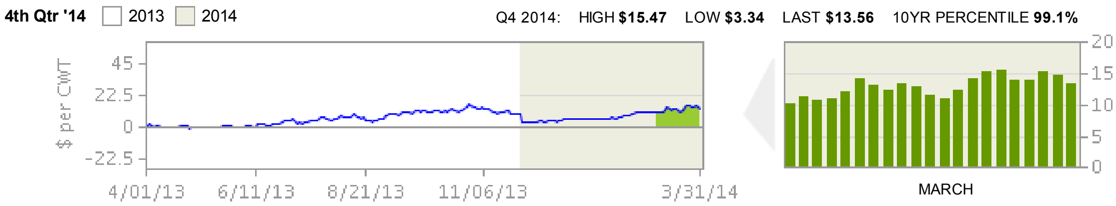
While other information such as fundamental changes in markets as well as seasonal or historical factors that may influence prices could be considered when ultimately determining strategies to protect the forward profit margin, a top down approach in first evaluating how strong or weak the projected margin represents will help the producer identify opportunities to begin protecting future profitability.

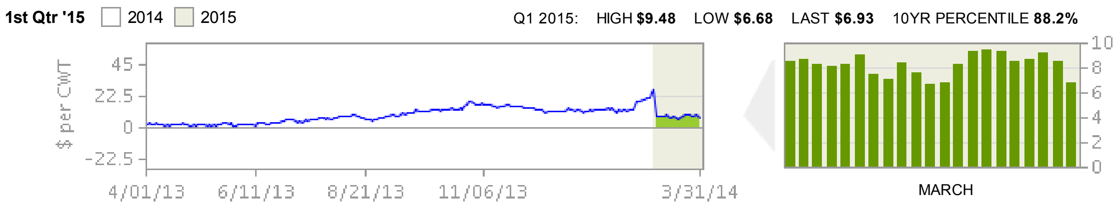
Hog Margin Watch: March

Deferred hog margins strengthened further throughout the second half of March as ascensions in PEDv cases supported back month futures contracts while nearby hog margins have deteriorated somewhat over the period. Finishing margins remain over the 99th percentile of the previous 10 years throughout the remainder of 2014, with Q1 2015 margins at the 88th percentile. The USDA recently released its quarterly hogs and pigs report, revealing a 3% drop from last March for hogs and pigs inventories at 62.899 million head, near the top of the pre-report range of estimates. Producers have continued to put more weight on finished pigs amounting to nearly 3% heavier marketed animals year-over-year keeping total pork production at nearly unchanged from last year. Farrowing intentions for the coming quarter were also above expectations at 2.4% above last year. While breeding intentions and market weights continue to creep higher in an effort to meet demand, producers and buyers are aware those efforts will likely not fill the coming hole in production through the August period. The USDA also recently released its quarterly grain stocks report showing corn stocks in all positions as of March 1 amounting to 7.01 billion bushels, up from 5.4 billion bushels last year. Soybean stocks in all positions were reported at 992 million bushels, 6 million bushels below last year's level and right on par with pre-report expectations. Although elevated, the March 1 corn stocks implies good demand for livestock feeding during the period, and slightly tighter ending stocks than previously forecast. Our consultants continue working with clients to evaluate net margins within the context of the open market. It may make sense in some cases to add flexibility back to deferred hog margins at a cost given the current uncertainty with PEDv and the potential production loss. The recent strength in corn continues to offer an opportunity to add flexibility back to price hedges as current supplies remain adequate to meet demand.









The Hog Margin calculation assumes that 73 lbs of soybean meal and 4.87 bushels of corn are required to produce 100 lean hog lbs. Additional assumed costs include $40 per cwt for other feed and non-feed expenses.

Three Questions With Hog Producers, Bob and Joe Dykhuis

Below you'll find a brief excerpt from a conversation between Margin Manager contributor, Brendan Dorais and Michigan hog producers, Bob and Joe Dykhuis. To view videos of the entire conversation, please visit www.cihedging.com/testimonials.

BD: Can you talk about your experience learning the margin approach?

BOB: We started out very basic in using futures and forward contracts through our suppliers and our market. Where now we have gone to using more spreads to manage basis risk and we have also used some options. I think we're learning more and trusting more on the advice but it's really our decision what we're trying to accomplish ... As we learn it's giving us more confidence to shape our business in the future.

BD: Can you discuss how the process of "scaling into coverage" has effected your decision making?

JOE: It changes the whole feel of your program from reactionary, "oh this is what the market's doing today, what do we do?" to more of a focused and strategic report where the volatility actually does becomes an opportunity to you because it does help you achieve the percentiles that you're trying to obtain.

BD: Would you say that executing a margin approach has reduced your stress level or is that still there?

BOB: Oh, we've been hedged out... to a year. at times! And *definitely* for me, and I think for Joe also, that really lowers the stress level, knowing that you have margins locked in and you kind of know what that is and bankers certainly act like they have less stress too.

> ***"We've been hedged out to a year at times ... Definitely lowers the stress level ... And bankers certainly act like they have less stress too."***
>
> ***Bob Dykhuis***

JOE: Well, getting the information into the website and keeping it all up to date and executing when you need to causes some stress. But it's a totally different kind of stress than worrying about the future. So, that's a worthwhile invesment.

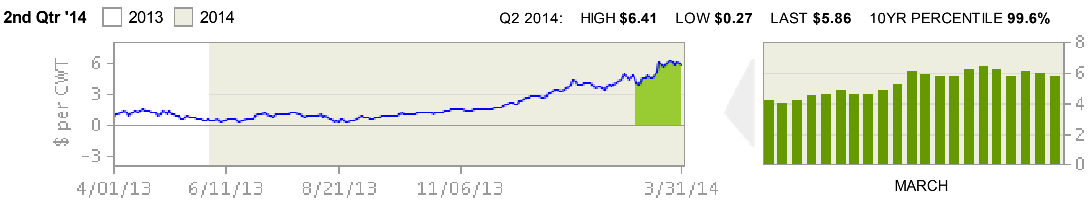
To watch the entire interview with Bob and Joe please visit:
www.cihedging.com/testimonials.

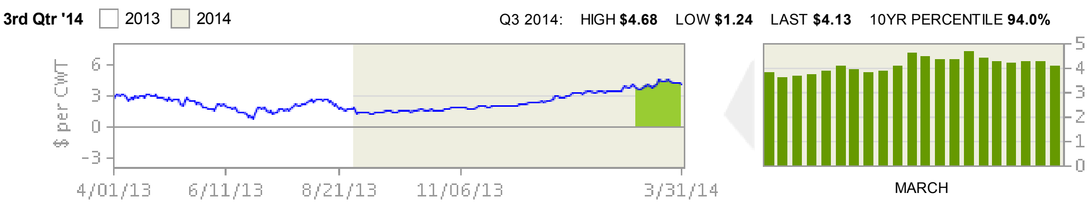
CIH will be conducting a full slate of educational programs in 2014. Learn more:
www.cihedging.com/education.

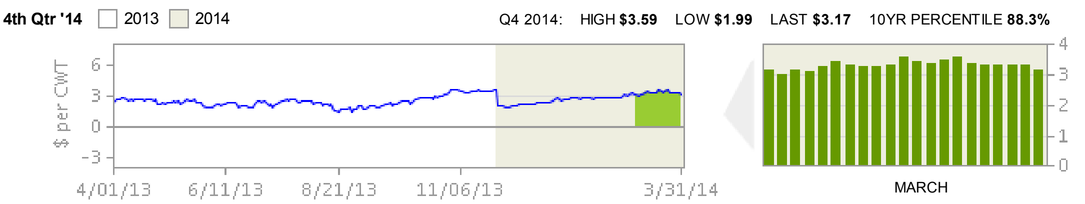
Know someone who might benefit from the margin approach? Call CIH at **(866) 299-9333** *or you can sign them up for this newsletter on our site.*

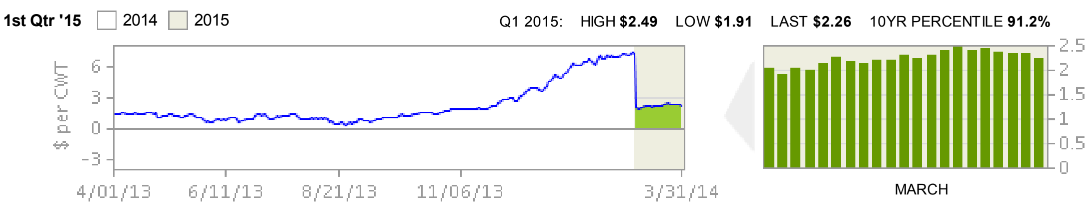
Dairy Margin Watch: March

Dairy margins have weakened slightly over the last half of March due mainly to higher feed costs as milk prices stayed elevated. Margins remain historically strong at or above the 90th percentile of the past ten years. Milk prices continue to be supported by record high cheese prices due to excellent export demand. Cheese prices once again achieved a new all-time high price last week only to come under some pressure last from weaker global prices. The CME cheddar blocks averaged over $2.40 per pound last week which represented a significant premium to both Oceania and European cheddar pricing, making U.S. cheese prices the highest in the world for the first time in nearly 15 months. Global milk production is currently on the rise; however, processors have been focused almost exclusively on filling milk powder demand rather than cheese demand. China's February imports of skim milk powder and whole milk powder amounted to 270.7 million pounds, nearly twice what they imported in February of last year and the second highest total on record in China for any month. The USDA recently released its quarterly grain stocks report revealing corn stocks in all positions as of March 1 at 7.01 billion bushels, up from 5.4 billion bushels last year and soybean stocks in all positions at 992 million bushels, 6 million bushels below last year's inventories at this time. Although ample at present, the March 1 corn stocks implies good demand for livestock feeding during the period, and slightly tighter ending stocks than previously forecast. Forward margins remain at historically high levels and attractive to protect. Our consultants continue to evaluate opportunities to both extend coverage as far out as 2015 while at the same time consider adding flexibility back to milk hedges given the underlying strength of the market. The recent strength in corn also offers an opportunity to add flexibility back to price hedges as current supplies remain adequate to meet demand.









The Dairy Margin calculation assumes, using a feed price correlation model, that for a typical dairy 62.4 lbs of corn (or equivalent) and 7.34 lbs of meal (or equivalent) are required to produce 100 lbs of milk (includes dry cows, excludes heifers not yet fresh). Additional assumed costs include $0.90/cwt for other, non-correlating feeds, $2.65/cwt for corn and meal basis, and $7.00/cwt for non-feed expenses. Milk basis is $0.75/cwt and non-milk revenue is $1.00/cwt.

Three Questions with CIH Dairy Margin Consultant, Will DeJong

Below you'll find a brief conversation between Margin Manager contributor, Brendan Dorais and Will DeJong. Will is a Client Services Manager with CIH's Dairy Margin Management Service. Brendan is CIH's Vice President of Business Development.

BD: What are some of the misconceptions out there that dairymen have about the margin approach?

WD: One popular misconception is that you have to time markets just right in order to have success. The margin approach is a long term process. We're looking to capture as much upside as possible while diminishing the downside as much as possible. As the market moves from highs to lows or the other way around, it's a constant process of repositioning yourself in order to capitalize on market movement. Since no one ever really knows which way markets are heading, we believe that it's always good to have a disicplined risk management policy in place.

Another popular misconception is that you need to have a massive cash flow available at all times. This is simply not true. There are a lot of low cost tools available to producers to effectively manage their margins. These range from non-marginable exchange positions to physical contracts through the processor or grain elevator. Another one is that producers should not use the exchange because they do not get paid Chicago prices. Even if you do not get paid exactly the Chicago Mercantile Exchange's (CME) prices, chances are that your mailbox price has a very strong correlation to either the Class III or IV market. It's our job here to find which exchange traded product is the best fit for your pay prices and to understand the advantages and disadvantages to using these markets and communicate those to the producer.

"As the market moves from highs to lows or the other way around, it's a constant process of repositioning yourself in order to capitalize on market movement."

BD: When is the best time to begin executing the dairy margin management approach?

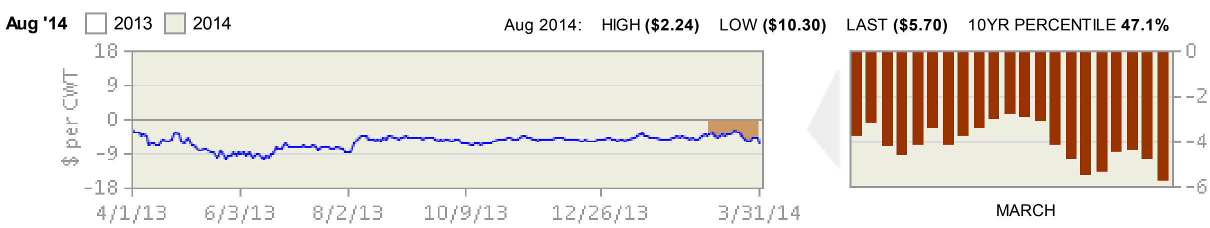
WD: More often than not, we see producers begin talking to us when milk prices are in the tank and there's not much margin available on the farm level. There's no one best time to be looking at protecting margins, but milk prices do follow a cyclical flow just like any other market and often the best opportunities are available after producers have gone through an extended period of positive margins.

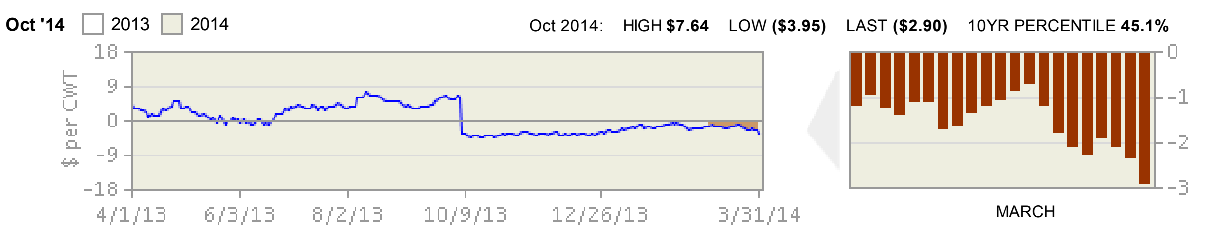
BD: Did growing up on a dairy influence your work as an AE?

I would say so. I believe this helps me identify more directly with producers and many of the struggles that they see on a day-to-day basis on the operation. I know dairymen are extremely busy and always putting out fires so there's definitely the need to be flexible with my schedule.

Spot beef margins were stronger over the last half of March while deferred 2014 periods saw margins weaken. April margins have continued to advance nicely as production continues to fall below year-ago levels. The USDA recently reported in its monthly cattle-on-feed report that marketed animals through the month of February were 1.55 million animals, 3% below 2013 and the lowest for the month since the data series began in 1996, helping to support nearby beef prices. Further helping nearby margins has been the recent surge in choice value with prices recently surpassing $240/cwt. Historically, choice and select values have a tendency to strengthen heading into May as packers and wholesalers measure the upcoming grilling season. While nearby margins currently project a profit, deferred margins from August into 2015 all project a loss at this point. Placements in February were reported at 1.65 million head which represents an increase of 15% over last year. Placements of animals weighing 600-700 pounds saw a 30% increase over 2013 at 330,000 head which will provide headwinds to August and October prices. Feed costs have continued to rise as corn ending stocks estimates continue to shrink. The USDA recently reported its quarterly grain stocks report revealing corn stocks in all positions as of March 1 at 7.01 billion bushels, up from 5.4 billion bushels last year at this time. Although ample at present, the March 1 corn stocks implies good demand for livestock feeding during the period, and slightly tighter ending stocks than previously forecast. Our consultants continue monitoring forward profit margin opportunities with clients particularly with nearby margins showing positive values. Some of our clients are considering adjustments on existing positions that reduce the delta of their corn hedges to take advantage of the recent price strength and add some flexibility back to corn hedges.

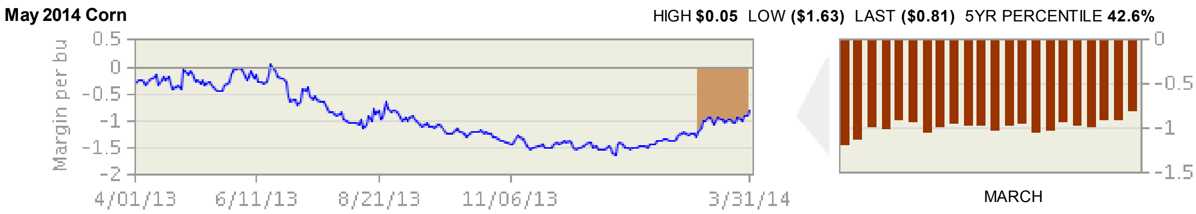
Live Cattle Marketing Periods:



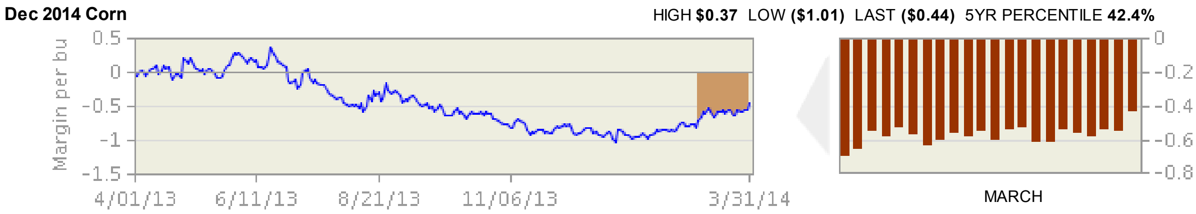


Corn Margin Watch: March

Corn margins were flat to slightly higher through the second half of March, improving primarily as a function of higher futures prices since the middle of the month. Margins remain negative for both old-crop and new-crop, and below average from a historical perspective. USDA released their Prospective Plantings and Quarterly Grain stocks reports, with the data supportive for corn from both the old-crop and new-crop perspectives. March 1 corn stocks were reported at 7.006 billion bushels, 30% above 2013 but 104 million bushels below the average trade guess, signaling higher disappearance during Q2 than what was expected. Indicated December-February disappearance was 3.45 billion bushels vs. 2.63 billion during the same period last year, with larger feed usage contributing to much of the variance from pre-report trade estimates. The figure suggests USDA will raise their feed and residual estimate in the April WASDE as a result. Meanwhile, 2014 corn plantings were preliminarily estimated at 91.7 million acres, down 3.655 million from last year and 1.2 million below the average trade estimate. There will be a clear shift out of corn into soybeans based on producer surveys as much of the Midwest will return to more of a traditional corn/soy acreage rotation following years of corn on corn due to stronger demand from the ethanol sector. Corn futures jumped about 10 cents in response to the report, although both nearby as well as deferred 2014 margins remain at the 40th percentile of the last five years. Our consultants are working with clients discussing margin protection of these forward values, and focusing on flexible strategy alternatives given the negative returns being indicated by current cost projections and basis quotes. Given that the market has strengthened recently, it would seem prudent to set a floor near current levels to minimize losses while preserving the opportunity for margins to improve over a range of higher prices.



The estimated yield for the 2014 crop is 166 bushels per acre and the non-land operating cost is $712 per acre. Land cost for 2014 is estimated at $239 per acre [1]. Basis for the 2014 crop is estimated at $-0.1 per bushel.



The estimated yield for the 2015 crop is 184 bushels per acre and the estimated operating cost is $712 per acre. Land cost for 2015 is estimated at $239 per acre [1]. Basis for the 2015 crop is estimated at $-0.25 per bushel.

[1] The Corn Margin Watch yield, land and non-land operating cost values are based upon central Illinois low productivity farmland crop estimates in the "Historic Corn, Soybean, Wheat, and Double-crop Soybeans" report published by the Department of Agricultural and Consumer Economics at the University of Illinois.

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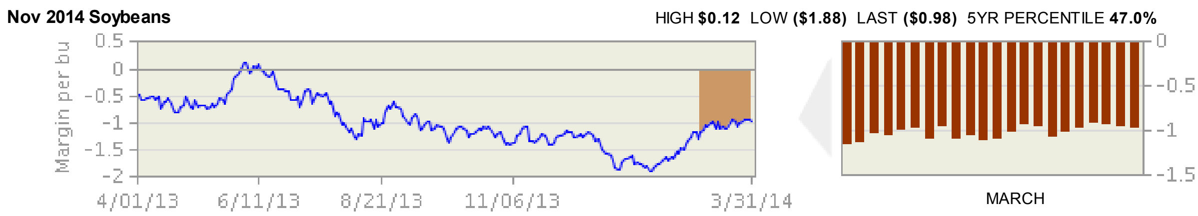
Soybeans Margin Watch: March

Margins were mixed since the middle of the month, improving for old-crop soybeans with continued strength in nearby futures and basis while remaining relatively flat for new-crop. USDA released their Prospective Plantings and Quarterly Grain stocks reports which were considered relatively neutral for both old-crop and new-crop soybeans. March 1 soybean stocks were reported at 992 million bushels, 6 million below last year and very close to the average trade estimate of 989 million. The figure confirms a tight old-crop balance sheet through the remainder of the marketing year, with indicated December-February disappearance of 1.16 billion bushels which would be up 20% from last year. Current projections from the March WASDE are likely accurate given the stocks figure, suggesting limited changes in the April report. A preliminary estimate of soybean plantings meanwhile pegs 2014 acreage at 81.5 million, up nearly 5 million acres from last year. Similar to March 1 stocks, the acreage figure was very close to the average trade pre-report estimate of 81.369 million, and considered largely neutral for price. Although new-crop soybeans sold off in response to the report, the market recovered most of its losses by the end of the session, drawing strength from old-crop prices which closed higher. Nearby margins are now at the 94th percentile of the last five years and deferred 2014 margins are now at the 47th percentile. Our clients have remained focused on managing positive old-crop margins while waiting for opportunities to protect new-crop margins which remain negative. Given that old-crop margins are now back above the 90th percentile, strengthening margin protection strategies would make sense following the recent strength in the market. Although new-crop margins are negative, flexible strategies can be considered which would preserve the opportunity for potential margin improvement over time from higher prices.

The estimated yield for the 2014 crop is 49 bushels per acre and the non-land operating cost is $434 per acre. Land cost for 2014 is estimated at $239 per acre [1]. Basis for the 2014 crop is estimated at $0.26 per bushel.



The estimated yield for the 2015 crop is 53 bushels per acre and the estimated operating cost is $434 per acre. Land cost for 2015 is estimated at $239 per acre [1]. Basis for the 2015 crop is estimated at $-0.15 per bushel.

[1] *The Soybeans Margin Watch yield, land and non-land operating cost values are based upon central Illinois low productivity farmland crop estimates in the "Historic Corn, Soybean, Wheat, and Double-crop Soybeans" report published by the Department of Agricultural and Consumer Economics at the University of Illinois.*

Commodity & Ingredient Hedging, LLC

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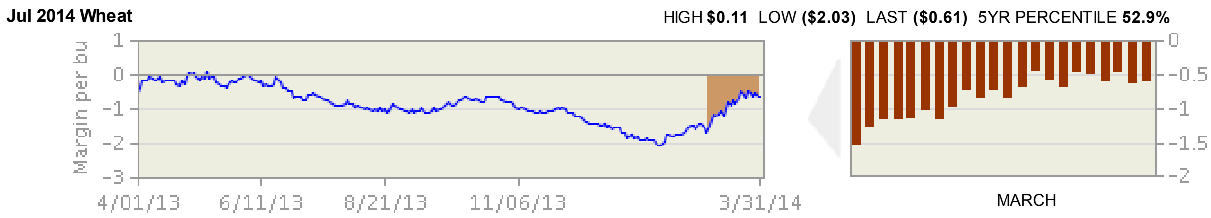
Wheat Margin Watch: March

Wheat margins continued to strengthen over the second half of March, although they remain negative for both old and new-crop positions. After a surge that carried futures values up nearly $1.00/bushel through the month, the market appears to have settled down. USDA released their Quarterly Grain stocks report which pegged March 1 wheat stocks at 1.055 billion bushels. The figure was 21 million bushels above the average trade guess and on the higher end of the range of pre-report estimates. While March 1 stocks are down 180 million bushels from 2013, the indicated December-February disappearance of 419 million bushels would still be 4% lower than last year. Meanwhile, USDA pegged all wheat plantings at 55.8 million acres, down 356,000 from last year and 210,000 below the average trade guess. Other spring wheat acreage was pegged at 12 million which was up 404,000 from 2013 but 164,000 below the average trade guess. Both the wheat stocks and acreage figures were considered relatively neutral, although the lack of any bullish surprises and the relatively high stocks figure clearly weighed on the market following the strong rally during the first half of the month. Both nearby as well as deferred 2014 margins are now at the 53rd percentile of the last five years. Our consultants continue working with clients to protect these forward margins with flexible strategies that will allow for potential margin improvement over time. Given the recent strength in futures, utilizing strategies that would protect a floor while allowing a range of higher prices to achieve a positive margin might make sense given that margins are closer to breakeven now following deeply negative values earlier this year.

The estimated yield for the 2014 crop is 67 bushels per acre and the non-land operating cost is $360 per acre. Land cost for 2014 is estimated at $150 per acre [1]. Basis for the 2014 crop is estimated at $0.28 per bushel.



The estimated yield for the 2015 crop is 65 bushels per acre and the estimated operating cost is $339 per acre. Land cost for 2015 is estimated at $150 per acre [1]. Basis for the 2015 crop is estimated at $-0.1 per bushel.

[1] The Wheat Margin Watch yield, land and non-land operating cost values are based upon central Illinois low productivity farmland crop estimates in the "Historic Corn, Soybean, Wheat, and Double-crop Soybeans" report published by the Department of Agricultural and Consumer Economics at the University of Illinois.

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