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Letter from the Managing Editor

Exploring the Seasonality of Margin Performance

Dear Ag Industry Associate,

After the brutal winter most of us endured, everyone is ready to turn the page on a new season. As spring is now firmly upon us, the focus has shifted to the typical array of topics that normally grab our attention this time of year. Planting progress and weather are always factors that influence price movements and can have a big impact on profit margins.

Our latest issue of *Margin Manager* explores the seasonality of margin performance and how this can influence your management of forward profitability. In addition, the *Margin Watch* reports go into detail on how the current slow pace of corn planting progress has influenced corn prices and the related forward profit margins for the hog, dairy, beef cattle and crop sectors.

Dispelling Myths About Margin Management

Also in this edition, *Margin Manager* contributor, Brendan Dorais sat down with CIH Account Executive, Ross Logan to discuss some of the common misconceptions about the margin approach and asked Ross to articulate why they are misconceptions. The interview took place at CIH's office in downtown Chicago.

Sincerely,

Chip Whalen
Managing Editor
V.P. Of Education & Research
CIH

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.

Futures and options trading involves the risk of loss.

ARTICLE

Exploring the margin management approach

Written by Chip Whalen, Managing Editor

Seasonality and Margin Management

Many producers know that there are certain times of the year which are more profitable than others. After all, agricultural commodities follow seasonal trends that can either pressure or support prices of the goods they use and produce. For example, crop producers often find that the value of their crops can be depressed at harvest time as an abundance of supply hits the cash market all at once. Likewise, dairy producers may find that milk prices tend to be depressed during the "spring flush" season which pressures margins in the early part of the year. Hog production ebbs and flows with pig supply and the weights at which animals are marketed. Hogs tend to pack on weight more easily heading into the fall and winter as temperatures decline and new-crop corn gets introduced into the feed mix. This can pressure the prices received for hogs and thus profit margins in the fourth and first quarters.

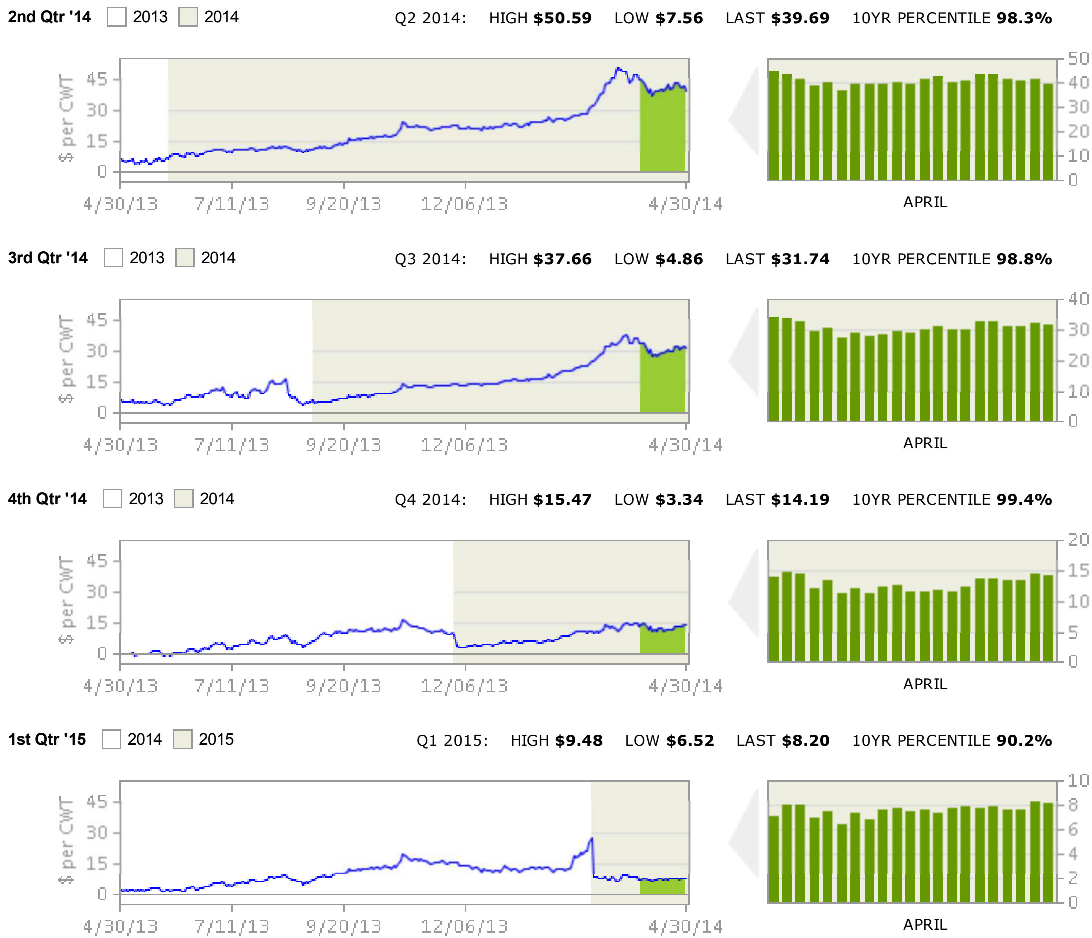
Understanding seasonal tendencies can play an important role in how a producer may want to approach managing forward profit margins. When we first started working with producers in the hog industry on margin management 15 years ago, many noted that they were not interested in protecting margins in the summer as that is when they make their money. They were more interested in focusing on the late fall to early spring period when margins tend to be depressed. What we learned however is that "part-time" margin management doesn't really work. During the spring of 2002 for instance, hog prices dropped precipitously in response to a trade spat with Russia where they stopped importing poultry from the U.S. to protest tariffs imposed at the time on Russian steel imports. This weighed heavily on finishing margins at a time of year that would otherwise have been considered a strong period for profitability.

While it may not be wise to try timing when to protect or stay open on margins, understanding seasonality may help refine the types of strategies to employ in a margin management plan. For example, if you are heading into a period where margins tend to be under pressure, it probably is a good idea to have a fair amount of coverage in place to protect those margins - even if the margin itself may not be historically strong. Moreover, if you understand the reason why the margin tends to be depressed, this may help guide you in the strategy selection process. For example, if I feed livestock and it is currently springtime, I know that the greatest period of uncertainty surrounding crop production is upon us. From how many acres will be planted to what the weather will be like during germination and reproduction to how many bushels will ultimately be harvested, this uncertainty can lead to increased volatility in crop prices over the summer. Understanding this, I may want to retain flexibility in the strategies I use to protect my feed costs. On the one hand, if there is a significant drought like we experienced a few years ago, I want to make sure I am protected against significantly higher prices. On the other, should we harvest a large crop later this year, I want to participate in the lower prices which could minimize my feed expense and improve my bottom line.

While seasonality can certainly play a role in the decision making process, it is important to remember that the market does not always behave according to seasonal tendencies. In any given year, the fundamental backdrop unique to that period may trump any seasonal pattern. Moreover, historical patterns are based on past price movements so seasonality itself is changing every year as new price activity gets added to the ongoing history. The profit margin itself should be the main driver of any strategic decision to manage forward profitability. Understanding seasonal tendencies can help refine strategies to protect both input costs and output revenues, though seasonality itself should not be the main decision making consideration. Understanding the seasonality of price movements or of overall profit margins can certainly assist in tactical strategy selection and position management over time. This may include decisions to include more or less flexibility at certain times of the year, taking on more cost in option positions, or even increasing coverage levels. A strong understanding of how seasonality affects prices and profit margins can help you make better decisions and give you more control over your profitability.

Hog Margin Watch: April

Hog margins were again mixed since the middle of the month, weakening slightly in spot Q2 but strengthening in all deferred periods through the first quarter of 2015. Margins remain well above the 95th percentile through the remainder of 2014, and right at the 90th percentile in Q1 of next year. The margin deterioration in spot Q2 over the past two weeks has been a function of lower hog prices and higher feed costs. The CME cash index has been steadily declining and now is at a discount to spot May futures which will converge with the index in another two weeks. While this has pressured the May contract and limited strength in June, deferred contracts have moved higher on continued concerns over hog supplies and pork production through the remainder of the year. The latest monthly Cold Storage report showed a much sharper drop in pork inventories during March than what was expected. USDA reported pork inventories down 12% from February during a time of year when supplies typically build heading into the summer grilling season. Pork inventories in cold storage were also 11.2% below last year as well as 2.2% under the five-year average. Corn prices meanwhile continue to draw support from the slow pace of spring planting. USDA pegged corn plantings at 19% complete through the week ending April 27 which was up 14 points from the same week last year but still 9% below the five-year average. Many areas of the northern and western Corn Belt are still too wet and/or cold to plant, and concern is growing that some of this acreage may eventually be switched to soybeans or enrolled into prevented planting should delays persist through the first half of May. Our clients continue evaluating opportunities to make strategic adjustments to existing positions, particularly adding flexibility back to feed hedges.



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.

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Written by Michael Liautaud, Editor

How do you Develop a Margin Management Plan?

Developing a Margin Management Plan

In a previous article, we discussed the importance of having a margin management plan and how it can benefit a producer by establishing a roadmap to help you get where you are trying to go. We receive many questions on how to put this plan together and what should go into it so that opportunities can be captured to protect attractive levels of profitability. While every business will be different in how they want to approach this, there are certain features in common that all margin management plans should incorporate.

Components of a Margin Management Plan

First, a margin management plan should state in simple terms what the business is trying to accomplish with their approach. This may be what some would refer to as a mission statement, and may read something like this: "We strive to maximize profitability in our business, and limit the impact of volatility on our returns over time." We like to think of this as a top-down approach, starting with an executive directive that strategically defines a goal then methodically spells out how that goal will be accomplished and carried out. If the goal is trying to maximize profit margins, a starting point may be to define a level of profitability that is acceptable. This may be a specific return on investment, dollar figure, or percentile of historical profitability. Whatever the goal, we first need to define it so we have a target to shoot at.

Next, we have to establish how to monitor opportunities so that we know when a target has been achieved. In order to do this, we need to construct a model that accurately represents our business and takes into consideration all of the unique costs, revenues and other factors in our operation. Once we have refined that model so that it captures the

> *"All margin management plans should specifically define the roles and responsibilities of those individuals within the organization who will be carrying out the plan."*

present state of our operation as it exists today, it then must be maintained and updated as we move forward in time to incorporate any changes that will impact our forward profitability. This gets us to the next point which is defining who will be responsible for maintaining the model to make sure that it accurately reflects our forward opportunities.

All margin management plans should specifically define the roles and responsibilities of those individuals within the organization who will be carrying out the plan. This may be as few as a couple such as a husband and wife in a family business, or as diverse as a whole team in a large company with specialized roles. In either case, strong communication will be necessary to assure that the plan is being carried out as envisioned. A good discipline to foster strong communication is determining a set time to review and discuss the plan on a regular basis. This will help assure that all of those involved with the process are kept informed on how the plan is being executed and how everyone's individual contributions to the process are being coordinated.

A margin management plan should also define all the methods that will be used to contract for both purchases and sales, as well as a means to track these such that coverage of both inputs and outputs are kept in balance. This is a complex process that also will vary a great deal from one

(Continued on Next Page)

Q&A Answering questions about margin management

Written by Michael Liautaud, Editor

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business to another. For starters, all the various contracting means should be spelled out along with what parties will be contracted with. If for example the company will be using exchange-traded derivatives as part of their margin management plan, who will they execute these strategies with? Moreover, what are the capital requirements of various positions they may use and where will this capital come from? It may be necessary for instance to engage a lender and obtain a line of credit specifically for hedging forward margin opportunities. How far forward in time will margin opportunities be identified and what percentage of production will be contracted? All of these considerations may help refine the types of strategies and contracts a business will use depending on the level of capital available to allocate to the effort.

Once the strategies to be used have been identified, it then becomes necessary to determine how they will be employed in executing the margin management plan. Perhaps for example a business will choose to scale into coverage at incrementally higher historical margin percentiles as opportunities present themselves. They may also elect to make adjustments over time to positions previously contracted as margins and/or prices change. What events might trigger these adjustments? A margin management plan can help spell out the more granular details of this strategy execution. At a minimum though, a basic component of any margin management plan should clearly state under what conditions positions will be both initiated and offset to help ensure the integrity of the contracting process. Finally, like any business plan, a margin management policy should be evaluated periodically to make sure it remains relevant to the goals and objectives of the business in addition to the roles of those of those involved with it. We have certainly seen that those operations with clearly defined plans get the most out of the margin management approach.

2014 SEMINAR SCHEDULE

Margin Management for Lenders
May 28-29 (Chicago)

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Includes Cubs game!
June 4-5 (Chicago)

Beef Margin Management
July 8-9 (Kearney, NE)

Crop Margin Management
July 9-10 (Chicago)

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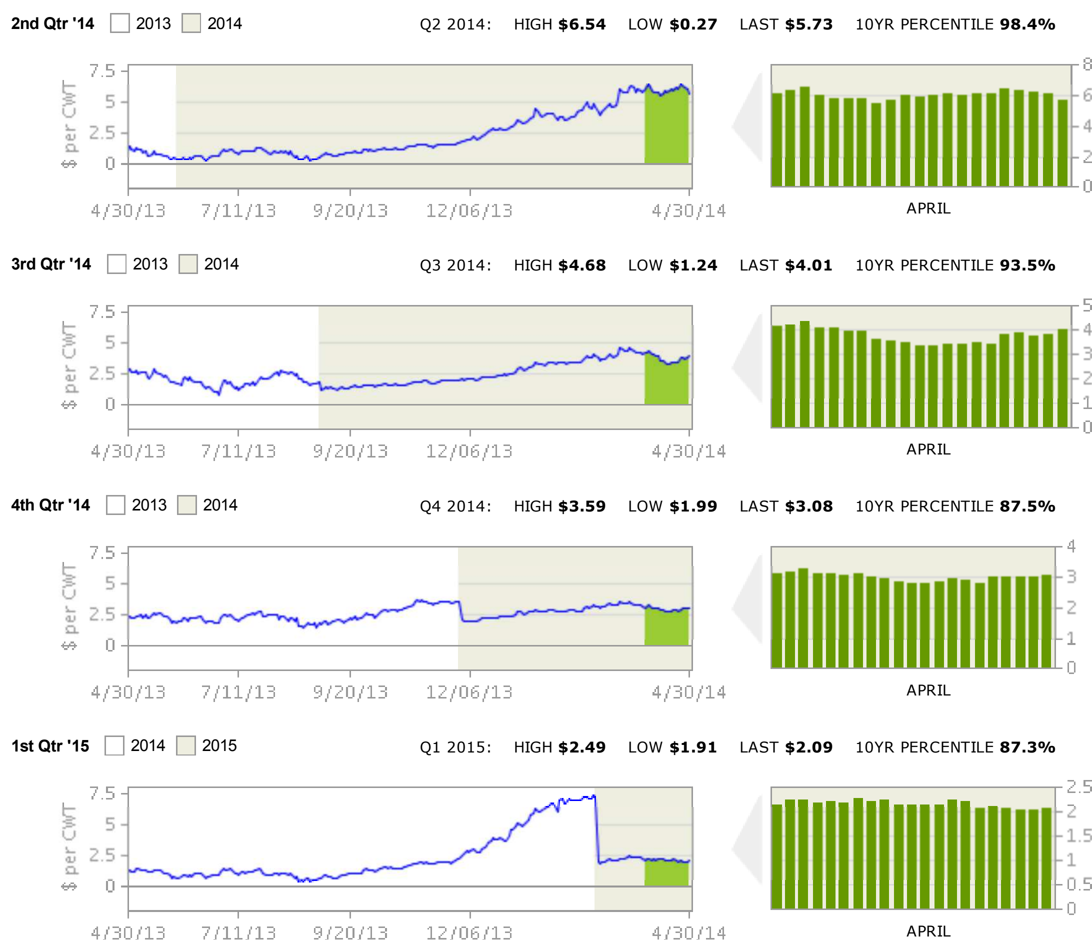
Dairy margins were mixed since the middle of the month, weakening slightly in spot Q2 but strengthening through the remainder of 2014. The first quarter of 2015 was also down slightly over the past two weeks. Margins remain strong from a historical perspective, above the 90th percentile through Q3 while approaching the 90th percentile in deferred periods. Milk prices have generally been stronger since the middle of April although feed costs have likewise moved higher. USDA reported the April 2014 Class III Milk price at a new record high of $24.31/cwt., up 98 cents from last month while the April All-Milk price of $25.50 also represented a new high. Nearby margins have been pressured slightly as spot cheese prices have dropped more than 28 cents/lb. since the beginning of April which will weigh on the May Class III price, while feed costs have also advanced during the month. Corn prices continue to draw support from the slow pace of spring planting progress. USDA reported corn planting at 19% complete through April 27th which is up 13% from last week but still 10 points below the 10-year average for planting progress as of this date. Most of the progress last week was made in southern states, and concern is mounting that intended corn acres in the Northern and Western Corn Belts may either get switched to soybeans or possibly enrolled in prevented plantings should current weather trends continue as it has been too cold and wet to advance progress. Soybean meal prices have also marched to new highs as they continue drawing support from tight old-crop supplies. Our clients continue to focus on opportunities to make strategic adjustments to existing positions. Adding flexibility back to both milk and feed hedges has been a particular feature recently.



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.

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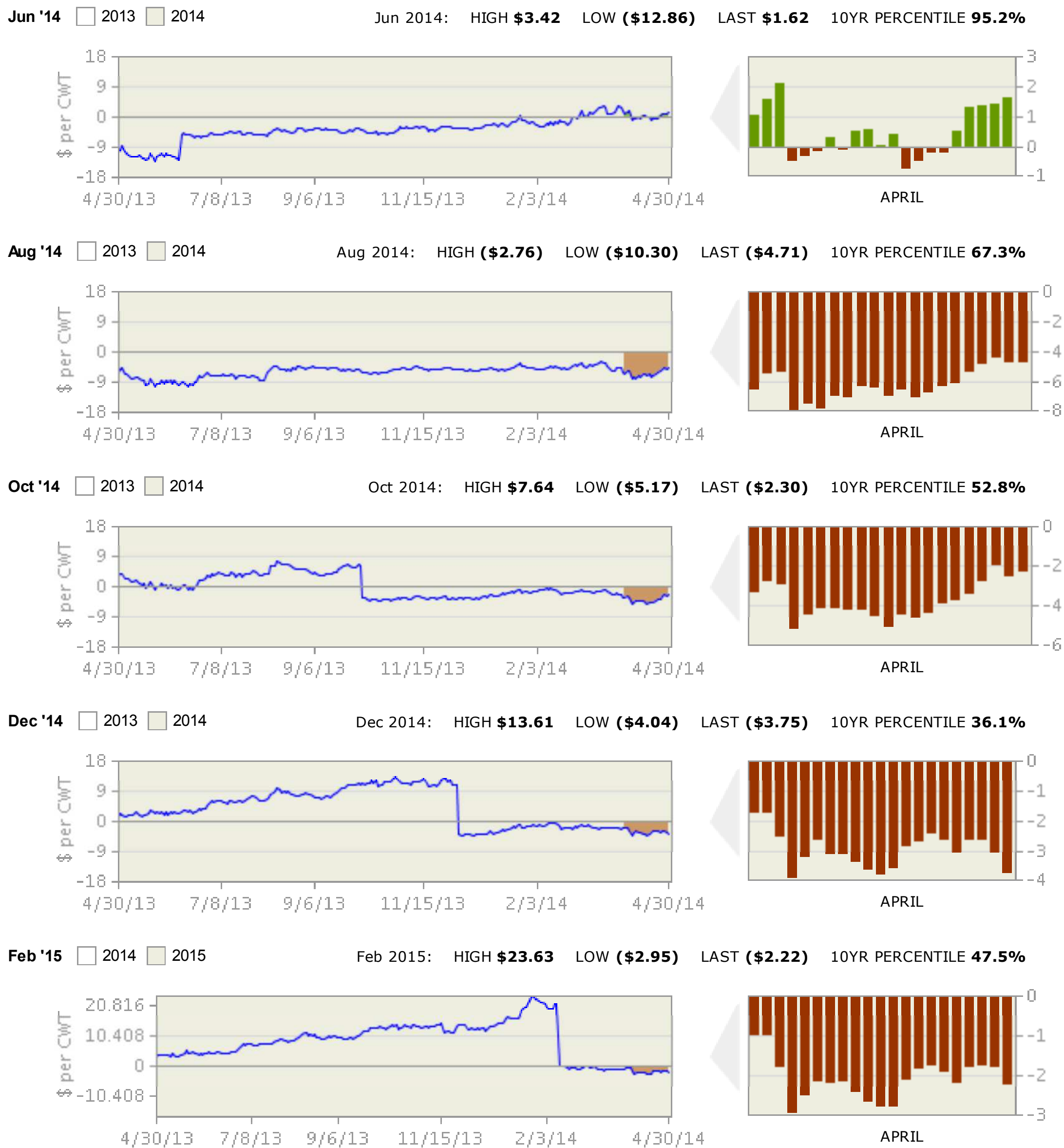
Beef Margin Watch: April

Beef margins were mixed since the middle of April, improving in nearby periods where feeder cattle are already priced and particularly where feed costs have largely been secured, but deteriorating further in deferred periods where all three legs of the margin remain open. As has been the case for some time now, only spot margins against the June marketing period are showing a profit with all deferred margins in the red and generally below average from a historical perspective. While cattle prices remain high, the tight supply of feeders is keeping pressure on margins with recent strength in corn adding to that pressure. Cattle prices are drawing support from a friendly Cold Storage report along with the latest Cattle on Feed numbers which reflected cattle placements below expectations. USDA showed March cattle placements at 1.795 million head, down 4.7% from last year and contrary to expectations which on average pegged placements up 1.6% from 2013. Total placements of heifers and their percentage of the total number of cattle in feedlots signal that heifer retention has been a priority as the industry tries to rebuild the beef cattle herd. Corn prices meanwhile continue to draw support from the delayed pace of planting progress, with USDA reporting that corn planting was 19% complete through the week ending April 27. While the figure was up 13% from the week before, it remains 10 points behind the 10-year average for this point in the season. It remains too cold and wet to plant in regions of the Western and Northern Corn Belts, and concern is growing that more of this acreage may eventually get switched to soybeans or enrolled in prevented planting. With forward margin opportunities limited in deferred marketing periods, many of our clients continue to evaluate opportunities making adjustments on existing positions. In particular, adding flexibility back to corn hedges has been a focus recently.

Live Cattle Marketing Periods:



The Beef Margin calculation uses Feeder Cattle futures to price inbound animals and assumes each will consume 55 bushels of corn and cost approximately $250 per head (for other feed and non-feed expenses) to gain 550 pounds and reach a market weight of 1,250 pounds.

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Corn Margin Watch: April

Corn margins have risen slightly since the middle of April as farmers entered fields for the new season. U.S. planting has begun in the Midwest with NASS reporting that 19% of the intended crop has been seeded compared to 28% complete on a 5-year average. Although behind, the current pace is ahead of last year's 5% seeding pace. Weather forecasts currently call for a dry period in the 10-day outlook which should allow plantings to advance nicely. On the demand side, weekly ethanol runs have continued to keep pace with the USDA estimate as production margins remain positive. Export sales and shipments remained strong to finish April. Exporters have committed 1.728 billion bushels or 99% of the USDA estimate for sale with four months remaining in the crop year. Currently, exporters have shipped out 63% of the USDA forecast compared to 66% on average. Corn shipments will now take priority at export terminals as soybean export demand fades. On the global front, China recently requested all shipments of both corn and DDGs into the country have certification that they are free from MIR162, a genetically modified strain of corn. The move will likely slow corn and DDG trade to China even further. Nearby margins are currently at the 43rd percentile of the last five years while deferred 2014 margins are at the 44th percentile. Our consultants are working with clients discussing margin protection of these forward values, particularly in the New Crop position, focusing on flexible strategy alternatives given the negative returns being indicated by current cost projections and basis quotes. Given that the market has remained strong, it continues to 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 $583 per acre. Land cost for 2014 is estimated at $239 per acre [1]. Basis for the 2014 crop is estimated at $-0.12 per bushel.

The estimated yield for the 2015 crop is 184 bushels per acre and the estimated operating cost is $688 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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Q&A Answering questions about margin management

Written by Ross Logan, CIH Consultant

What are the most common misconceptions about the margin approach?

Misconception #1: If I implement a margin management plan, I will not be able to participate in market moves to the upside

This is a common misconception. By scaling into higher levels of margin coverage as the opportunity improves and utilizing flexible option strategies, a producer can protect forward margins and improve his positions. They can also manage a position over time and further improve their margin by making adjustments that strengthen their position. This will allow them to benefit from fluctuations in the market.

Misconception #2: Engaging in a margin management plan takes up too much time.

This is one of the huge benefits of working with a consulting firm like CIH. Few producers have the time and resources to efficiently carry out this process alone. By working with your CIH consultant to outline a margin management policy and utilizing our proprietary online software you can project forward margins with a mouse click. By utilizing these two resources, many of my clients are able to devote less than one hour per week towards margin management.

Misconception #3: Isn't it really just buying puts and selling calls?

Buying puts and selling calls is simply one of many tools in the Margin Management toolbox. To be an effective margin manager, using the right strategy, based on the producer's need and risk, is paramount. A few of the common strategies used include: futures, calls, puts, forward price contracts, and basis contracts. In many cases a combination of strategies are used, based on the opportunity for that particular portion of the margin.

Misconception #4: All Margin Management programs are the same, and we already do that in-house.

This is simply false. Every Margin Management program should be different because very few operations are alike. This is the difference between trading a generic crush, and managing an individual margin. Although the basic components of a producer's margin are similar, every producer's operation, cost structure, and goals are unique. By getting to know our clients and their operations we build an individually based model. This allows us to project each client's forward margin opportunities. A personalized approach is one of many things that sets CIH Margin Management apart from other "cookie cutter" type margin programs.

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Soybeans Margin Watch: April

Both nearby as well as deferred 2014 soybean margins increased marginally to finish April. Old crop demand prospects are beginning to balance with supplies as export sales and shipments have slowed to a near halt recently. Export sales remain at 104% of the USDA year-end expectation as very little business has transacted over the last two weeks. The shipment pace remains elevated at 98% shipped compared to 82% on average for this time in the crop year. The marketplace is beginning to witness modest export sales cancellations which would be required to justify the USDA's balance sheet. Imports from South America are also arriving at eastern ports. Further imports and continued export cancellations would be required to ultimately resolve the USDA's expectation of 135 million bushels in ending stocks for the 2013/14 crop year. New crop export sales are also quite strong as exporters have already committed 286 million bushels for future delivery. Current commitments are the third largest in history for this time of year. U.S. farmers have started planting in the Midwest with NASS recently reporting 3% of the intended crop has been seeded compared to 4% on average. Weather prospects remain favorable over the next 10 days for continued planting progress. Nearby margins are now at the 98th percentile of the last five years and deferred 2014 margins are now at the 59th percentile. Our consultants are working with clients to manage these forward profit margins. Given that old-crop margins are back above the 95th percentile, some of our clients continue to consider strengthening margin protection strategies as supply and demand factors are beginning to balance. Some of our clients are evaluating protection strategies on new-crop margins that provide protection to all lower prices while retaining the flexibility to participate in higher margins should prices improve further.

The estimated yield for the 2014 crop is 49 bushels per acre and the non-land operating cost is $330 per acre. Land cost for 2014 is estimated at $240 per acre [1]. Basis for the 2014 crop is estimated at $0.15 per bushel.

The estimated yield for the 2015 crop is 53 bushels per acre and the estimated operating cost is $319 per acre. Land cost for 2015 is estimated at $240 per acre [1]. Basis for the 2015 crop is estimated at $-0.2 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.

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Wheat Margin Watch: April

Wheat margins have remained volatile to finish April, ultimately finishing higher. The Quality Council Tour has begun in Kansas with initial reports from the fields. Yield disappointments have been reported in eastern Kansas with yields trending lower as the tour headed west. As expected, yields in western Kansas were reported near last year's levels from the teens into the low 20s. Winter conditions have stabilized recently; however, rains are needed to prevent further deterioration. Spring wheat planting has moved ahead of last year's slow pace with NASS reporting 18% of the intended crop has been planted compared to 11% last year and 30% on average. On the global front, weather prospects in the E.U. and Black Sea region are favorable as above normal precipitation and moderate temperatures have been witnessed. The prospects for record world production remain and will create significant competition to the U.S. export market in the coming months. Tensions between Ukraine and Russia have escalated and the fear of a Black Sea export halt continues to keep a bid beneath the U.S. market. Nearby margins are now at the 66th percentile of the past five year with deferred 2014 margins now at the 65th percentile. 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 $0.25 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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