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Feature Article

Forward Contracting Agreements (Part of new series of articles)

Margin Watch Reports

Dear Ag Industry Associate,

As we move into the harvest season, a lot of attention has focused on yields being reported and what that translates to for corn and soybean crop production. The USDA has also released some important reports this past month, including the Quarterly Hogs & Pigs and Small Grains summary that provided final ending stocks for the 2014-15 corn and soybean balance sheets. There has been quite a bit of volatility in the cattle and milk markets as well, and these factors have influenced the forward profit margins of crop, hog, beef and dairy producers. The latest installment of our *Margin Watch* reports detail how these and other developments have affected forward margins for these industries as we head into fall.

Meanwhile, the feature article this month begins our series into comparing contracting alternatives. In *Forward Contracting Agreements*, we discuss the characteristics of this type of contracting in the local cash market and the mechanics of how it works. Forward contracts are used extensively by agricultural producers to secure both costs and revenues for their operations, and they provide key benefits that are attractive to those who use them. One of these benefits however can also be a liability, and the article balances out this nuance so that we can compare it with the alternative of using a futures contract which we will cover in our next installment.

In discussing and comparing various contracting alternatives in the next few issues of *Margin Manager*, we want to highlight the features, benefits, advantages and disadvantages of how these contracts work. In doing so, it is our hope that producers develop a greater understanding of and make more informed decisions about these contracts to help better manage their profit margins.

Sincerely,

Chip Whalen
Managing Editor

Managing Editor, Chip Whalen is the Vice President of Education and Research for CIH, a leader in Margin Management. He teaches margin seminars throughout the country and can be reached at cwhalen@cihedging.com

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Forward Contracting Agreements

For the first article in our series of comparing contracting alternatives, we are going to review the features of a forward agreement in the cash market. A forward contract establishes a price between a buyer and seller for a particular commodity to be delivered from the seller to the buyer at some point in the future. The terms of the contract, including the amount or quantity of the commodity, the quality specifications, the specific delivery period, and any particular pricing determinants such as how premiums or discounts may be handled are directly negotiated between the buyer and seller in a private transaction. As an example, a crop producer may reach an agreement with a local elevator to sell a portion of their corn crop forward ahead of the spring planting season for fall delivery at harvest time. Let's assume this particular grower anticipates harvesting 100,000 bushels given normal yields, and wishes to establish a price on half of their production since current price levels would provide them with an expected return they are satisfied with. They may reach an agreement with the elevator to sell 50,000 bushels at a price of $4.00/bushel for delivery during the last half of October.

The $4.00 price is determined by referencing CBOT corn futures at the CME Group, and taking into consideration a local basis which represents the differential between that futures price and the anticipated discount to futures at harvest time. In this example, let us assume that December CBOT corn futures are trading at $4.25/bushel. The December futures price is referenced because of the agreed upon delivery period in the last half of October. Any spot transactions that would occur in the cash market during this timeframe would reference the December futures contract price as a benchmark, so it therefore would likewise be referenced for this hypothetical forward agreement. The differential or basis in this particular example would therefore be -$0.25/bushel, derived from the agreed upon forward price of $4.00/bushel minus the futures price of $4.25/bushel. We will assume that a "normal" basis in this local cash market at harvest time is typically around 30 cents under futures, and the elevator is giving the producer a volume premium for agreeing to contract 50,000 bushels.

As part of determining the $4.00/bushel price, the contract stipulates quality specifications that may among other things limit the amount of foreign material or mycotoxins allowed to be present in a sample. Likewise, it may be agreed upon that a #2 yellow grade corn is to be received, with some sort of discount and premium schedule applied to quality below or above this threshold. Perhaps the most important aspect of the contract though is that it requires physical delivery of the actual corn. This presents risk to the seller in that they may not have the supply available at the agreed upon delivery period. This might arise from a delay in harvest for example, or a production issue such as a drought or flood which wiped out their crop during the growing season. While this particular producer may feel comfortable in that only half of their expected production has been contracted, this is something that needs to be considered as the elevator may require that bushels be replaced in the open market if the producer is not able to satisfy the delivery agreement with their own production.

The advantage to this type of contracting alternative is that the buyer and seller get to customize the terms of the agreement to their particular needs. In this example, it also provides a "home" for the commodity which may be an important consideration for the seller. Let's assume for instance that the producer does not have adequate storage on their farm for all of their expected production. It may be a priority to establish a guaranteed channel where these excess bushels can be delivered at harvest time, above and beyond what the producer is able to store. A dairy operation might likewise utilize a forward contract to make sure their fluid milk can be shipped in a timely fashion off their farm to a processor in the local market. In a similar way, a hog producer might want to ensure they have adequate shackle space for their marketing herd and also be drawn to using a forward contact in the cash market. The downside of this of course is that while they are guaranteeing an outlet for their production, they are doing so by committing physical supply to a counterparty at a set period of time in the future. As a result, they would want to feel

Forward Contracting Agreements
Continued From Previous Page

confident that they can actually deliver this supply, and may therefore not want to contract more than they are absolutely comfortable committing to ship.

Another advantage of this type of marketing arrangement involves cash flow considerations. While a price is agreed upon between the buyer and seller in advance, they do not settle up on that price commitment until the physical delivery takes place in the future. This can be either an advantage or disadvantage, but for many sellers, this is a source of comfort as they simply receive payment for their supply upon delivery and do not have to worry about cash flow on that production in the interim. In our next installment, we will discuss the features of a futures contract and how that differs from a forward contract in the cash market. As we will see in that article, this is a key point of difference in that futures have a daily settlement procedure where cash flow considerations come into play. A final benefit of using a forward contract is that oftentimes a delivered price can be established in advance. By having greater price certainty over a certain amount of production, it assists with planning and budgeting and allows a producer to have better visibility on their forward margins.

Hog Margin Watch: September

Margins were mixed over the last half of September, improving in nearby Q4 and Q1 while remaining relatively flat in deferred periods. Despite the improvement, hog margins are still negative in Q4 and only improved to a breakeven level in Q1 while remaining average to below average from a historical perspective further out in 2016. Margin movement over the past two weeks was characterized by slightly higher trade in hogs while feed prices were steady to weaker. USDA released their small grains report at the end of the month which provided the final 2014-15 ending stocks for corn and soybeans. The corn figure of 1.731 billion bushels was very close to the average trade estimate of 1.735 billion and thus considered neutral. The old-crop soybean ending stocks figure of 191 million bushels was about 13 million bushels below the average trade guess and considered somewhat friendly as USDA made revisions to lower last year's crop. USDA also released their quarterly Hogs and Pigs report which was similarly considered neutral by market participants. The all hogs and pigs figure for September 1 was up 3.66% from a year ago to a record large 68.395 million head with the breeding herd of 5.986 million sows up 1.1% from last year versus expectations for only a 0.3% increase. This may be construed as a little bearish relative to expectations. Moreover, the recent publication of the 2015 "Pork Powerhouses" which details the number of sows for the top 25 production operations in the U.S. showed an increase of 128,100 sows from last year or 3.9% which likewise indicates expansion. Our consultants continue working with clients to consider adjusting existing positions by strengthening soybean meal hedges as well as add flexibility to hog hedges to increase protection to lower prices.

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.

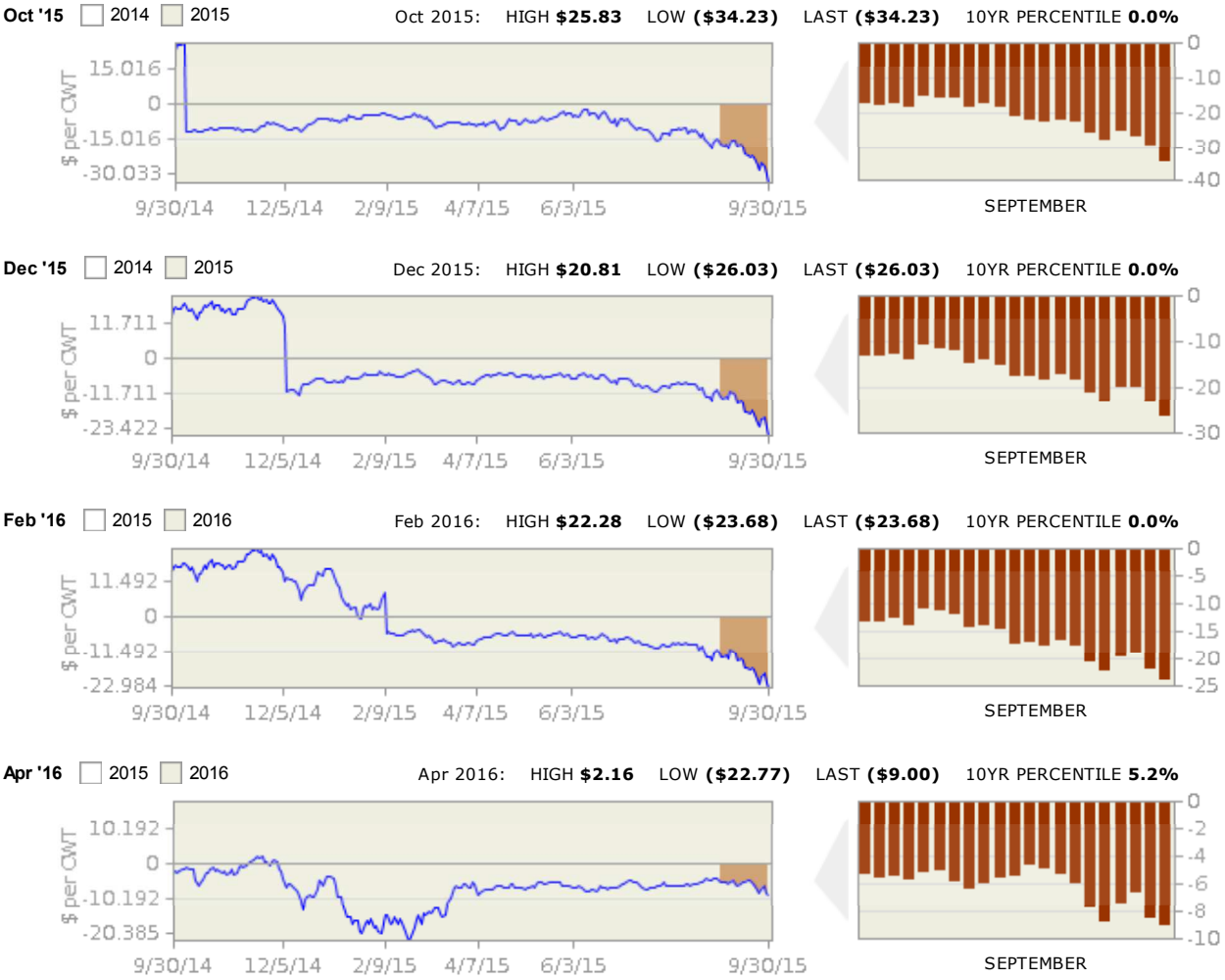
Margins were mixed over the past two weeks, weakening slightly in spot Q4 while improving slightly in deferred periods throughout 2016. The strongest margins exist in Q2 and Q3 which rank at or above the 70th percentile of the past ten years while nearby margins are only average to slightly above average from a historical perspective. Milk prices have been mixed recently, weakening in Class 3 though strengthening significantly in Class 4 due to a sharp rally in butter prices which recently eclipsed $3.00/lb. in the CME spot auction. Despite this strength, spot butter prices are down sharply in the past few days, dropping 63 cents from the recent high of $3.14/lb. USDA reported August milk production of 17.4 million pounds, up 0.8% from last year with the Upper Midwest and Northeastern states accounting for most of that growth as California milk production declined 3.4% from last year. USDA also released the small grains report which detailed final 2014-15 ending stocks for both corn and soybeans. The corn figure of 1.731 billion bushels was very close to the average trade estimate of 1.735 billion and thus considered neutral. The soybean figure of 191 million bushels was 13 million below the average trade guess, and construed as friendly with USDA making revisions to lower last year's crop. Despite this, soybean yield reports on early harvested fields have been very impressive and this combined with weakening interior basis levels has pressured soybean meal futures recently. Our consultants continue working with clients to optimize milk hedges in light of the pricing differentials between the two milk classes while also evaluating other adjustments to existing positions. Strengthening soybean meal hedges for protein needs has been a particular area of focus.

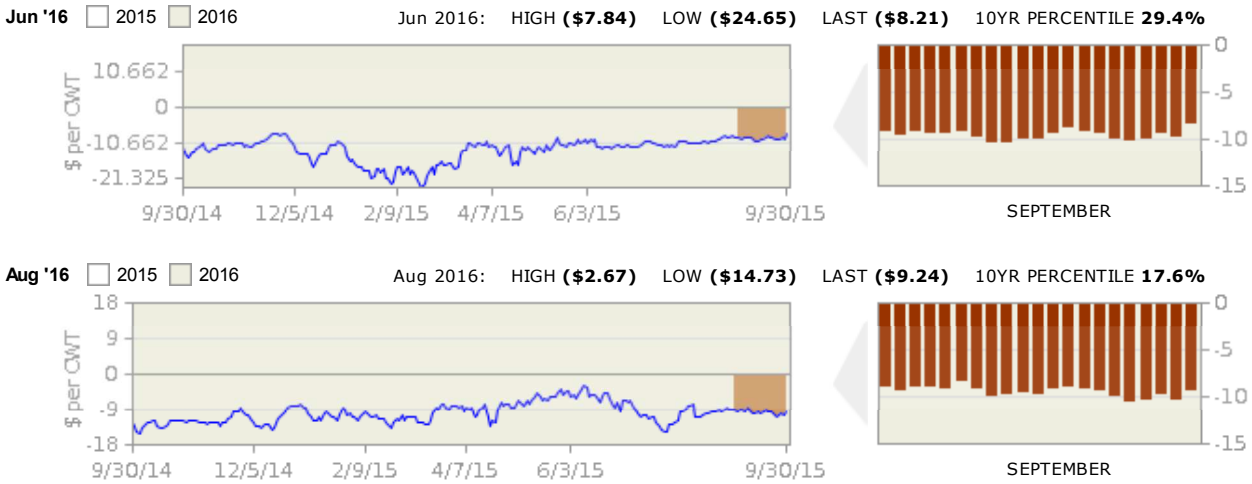
The Dairy Margin calculation assumes, using a feed price correlation model, that for a typical dairy 62.4 lbs of corn (or equivalent) and 7.34 lbs of meal (or equivalent) are required to produce 100 lbs of milk (includes dry cows, excludes heifers not yet fresh). Additional assumed costs include $0.90/cwt for other, non-correlating feeds, $2.65/cwt for corn and meal basis, and $8.00/cwt for non-feed expenses. Milk basis is $0.75/cwt and non-milk revenue is $1.00/cwt.

Beef Margin Watch: September

Cattle finishing margins deteriorated sharply since the middle of the month due to a sharp drop in cattle prices over the past two weeks with corn prices holding relatively steady. Forward margin opportunities remain non-existent well into the summer of 2016, with costs well above projected revenues. USDA released the small grains report which detailed the final 2014-15 ending stocks for both corn and soybeans. The corn figure of 1.731 billion bushels was very close to the average trade estimate of 1.735 billion and thus considered neutral. Early harvest results have been mixed but generally in line with current USDA expectations based on the September WASDE report, with the forecast appearing favorable into the first half of October to continue harvest progress. USDA's August Cattle on Feed report showed the total supply of cattle on feed as of September 1 at 9.986 million head, up 2.7% from last year when the market was expecting a 3.7% increase. Moreover, August placements of 1.632 million head were down 5.4% from last year when the market was expecting placements of cattle into feedlots up 0.3% from 2014. While on the surface the report seemed somewhat bullish, it also showed the amount of cattle on feed for 120 days or longer up 18% from a year ago and also up dramatically compared to 2013 and the five-year average. Pressure in the cash market to move heavy cattle appears to be weighing on futures at a time of year when demand typically wanes from the end of the summer grilling season and the transition to fall features in the retail meat case. Beef stocks in Cold Storage during August also saw a year-over-year increase of 36% to just over 470 million pounds. Our clients are focused on making adjustments to existing positions given the lack of forward margin opportunities, extending downside coverage and adding flexibility on cattle hedges to participate in higher prices.

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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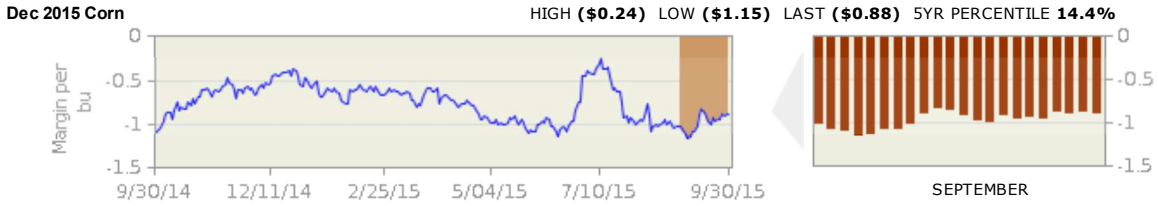
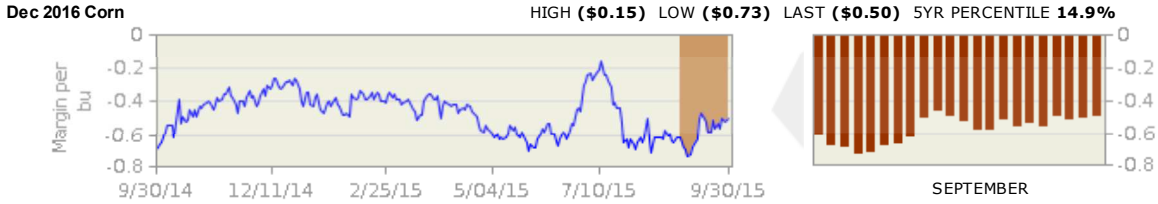
Corn Margin Watch: September

Corn margins were steady over the past two weeks, and remain in the red. The USDA released the quarterly update on corn stockpiles which were forecast to be 1,731 million bushels. The new estimate was just 4 million bushels less than analysts' pre-report expectations and only 1 million bushels less than the USDA estimate of stockpiles in the September WASDE report. A breakdown of total stocks estimates 593 million bushels stored on farm, while off-farm stocks are 1,138 million bushels or 28% and 48% greater than last year respectively. On the demand side, export sales for new crop corn remain soft, with cumulative sales of 413 million bushels of corn, which is 22.4% of the current pace to meet the USDA forecast of total exports of 1,875 million bushels. The average pace of export sales over the last ten years at this point in the marketing cycle is 30.5%. The USDA is currently estimating corn exports to be 25 million bushels less than last year, while estimating soybeans to be 110 million bushels less. The strong US dollar and abundant worldwide supplies continue to impact US export potential, giving importers ample alternatives that are currently cheaper than US origin corn. The next crop report is due October 9th and will reveal updated production, yield data and acreage estimates, as well as some potential adjustments to the demand categories. The acreage forecast will incorporate data from FSA that includes actual corn acres enrolled in their programs. NASS will also be using updated farm and field surveys to hone in the yield estimate, some of which are able to incorporate actual harvest figures off the combine. The most recent harvest progress was reported to be 18% complete, behind the five year average of 23% complete, however expectations are for the corn harvest to catch the average in short order. Favorable current extended weather forecasts offer farmers a window of opportunity to get in the fields to finish this year's harvest. The prospect of crop diminishing frost or freeze damage does not appear to be a threat in the near term. As harvest advances our consultants are working with clients to adjust positions to fit the current market conditions, as well as set targets to capitalize on favorable forward margin opportunities as they occur.



The estimated yield for the 2015 crop is 182 bushels per acre and the non-land operating cost is $595 per acre. Land cost for 2015 is estimated at $246 per acre [1]. Basis for the 2015 crop is estimated at $-0.14 per bushel.



The estimated yield for the 2016 crop is 184 bushels per acre and the estimated operating cost is $586 per acre. Land cost for 2016 is estimated at $236 per acre [1]. Basis for the 2016 crop is estimated at $-0.14 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.

Soybeans Margin Watch: September

Soybean margins were steady the past two weeks and still offer negative margin opportunities. The USDA released the quarterly update on soybean stockpiles at 191 million bushels, 13 million bushels less than analysts' pre-report expectations but still more than double September of 2014 ending stocks of 92 million bushels. Soybeans held on farm totaled 49.7 million bushels, also more than double last year. Off-farm stocks were estimated to be 141.73 million bushels, a 77.2% increase over last year. The USDA also revealed adjustments to the 2014 soybean balance sheet. The USDA stated the changes were based on an analysis of end-of-marketing year stock estimates, disappearance data for exports and crushings, and farm program administrative data. As such, 2014 production was revised to 3.93 billion bushels, down 41.7 million bushels from the previous estimate. Planted acres were revised down 425,000 thousand acres to 83.3 million acres and harvested acres were revised down 470,000 thousand acres to 82.6 million acres. The 2014 yield was shaved 0.3 bpa to 47.5 bpa. The soybean market had been anticipating these adjustments given the higher than normal residual component the USDA had been carrying on the balance sheet. The next crop report is on October 9th and will reveal new estimates on area planted and harvested, yield and production, as well as updated demand forecasts. While new crop soybean export sales are estimated to be lower than last year by 110 million bushels they received a shot in the arm recently as a delegation from China signed letters of understanding to purchase 13.2 million metric tons (roughly 485 million bushels) of soybeans from the US. There is some uncertainty as to which crop years these commitments will be fulfilled. At last reading cumulative sales of 759 million bushels represents a current pace of 44.0% to meet the USDA export sales target versus an average pace over the past ten years of 45.6%. Harvest progressed by 14 points last week advancing to a reading of 21% complete versus the five year average of 16% complete. The extended forecast looks to offer combines the freedom to continue to roll, without much interference from Mother Nature. As harvest advances our consultants are working with clients to help evaluate current protection strategies and make adjustments to capture equity while maintaining protection to lower prices, as well as set targets to capitalize on forward margin opportunities as they occur.

The estimated yield for the 2015 crop is 52 bushels per acre and the non-land operating cost is $365 per acre. Land cost for 2015 is estimated at $246 per acre [1]. Basis for the 2015 crop is estimated at $-0.2 per bushel.

The estimated yield for the 2016 crop is 53 bushels per acre and the estimated operating cost is $362 per acre. Land cost for 2016 is estimated at $236 per acre [1]. Basis for the 2016 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.

Wheat Margin Watch: September

Wheat margins continued to show modest improvement over the past two weeks, but also continue in negative territory. The Grain Stocks and Small Grains Summary reports offered wheat stockpile estimates and final all wheat production for 2015. All wheat stocks of 2,089 million bushels were well below the pre-report expectations of 2,165 million bushels, yet still 10% greater than September of 2014. The stocks estimate was the result of reduced all wheat production. Planted and harvested acres were both reduced by approximately 1.4 million acres, while yields were shaven by 0.5 bpa. As a result production was 84 million bushels less to total 2,052 million bushels. The all wheat balance sheet will reflect these updated estimates on the next crop report to be released on October 9th. Wheat exports are running behind the pace needed to meet the USDA's 900 million bushels of wheat exports this marketing year. The current pace of sales at 45.3% of the estimate is versus the average pace of 55.4% over the past ten years. The strength of the US dollar and ample global wheat supplies are giving importers plenty of alternatives to US origin wheat. US winter wheat planting is 31% in the ground, four points behind the five year average. The wheat seeds are being sown into soil that is adequately fortified with moisture. The western and southern Russian growing areas are not as lucky; those winter wheat seeds are going into soils that are dry and in need of moisture. Our consultants are working with clients after the reports to adjust positions to current conditions and expectations, while also setting alerts to capture favorable margin opportunities as they occur.

The estimated yield for the 2015 crop is 67 bushels per acre and the non-land operating cost is $358 per acre. Land cost for 2015 is estimated at $166 per acre [1]. Basis for the 2015 crop is estimated at $-0.15 per bushel.

The estimated yield for the 2016 crop is 68 bushels per acre and the estimated operating cost is $359 per acre. Land cost for 2016 is estimated at $158 per acre [1]. Basis for the 2016 crop is estimated at $-0.15 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.