Winter 2019-20 Alkire Advisory Education Series

Module 3: Use YOUR Best Marketing Alternative to Maximize Farm Profits

Completing a Crop Marketing Plan dramatically improves your odds of Making Money Farming in 2020!

Those who believe in their cost of production sell with confidence at our scale-up price goals because they understand it is the first step in protecting desirable profits for the crop year.

Alkire Advisory Crop Marketing Plan **EXAMPLE**

2020-21 Profit/Loss				Updated:	12/19/2019
	Acres	Yield		Acres	Yield
CORN	500	180.0	SOYBEANS	500	50.0
Profit Goal	Total Bu:	90,000	Profit Goal	Total Bu:	25,000
$70.00	Breakeven	w/Profit	$50.00	Breakeven	w/Profit
Costs:	$700.00	$770.00	Costs:	$500.00	$550.00

--- Net Profit per Acre ---

CORN	Expected	5%	-5%	15%	-15%
Price/Yield	180.0	189.0	171.0	207.0	153.0
$5.00	$200.00	$245.00	$155.00	$335.00	-$5.00
$4.61	$129.80	$171.29	$88.31	$254.27	-$64.67
$4.50	$110.00	$150.50	$69.50	$231.50	-$81.50
$4.00	$20.00	$56.00	-$16.00	$128.00	-$158.00
$3.50	-$70.00	-$38.50	-$101.50	$24.50	-$234.50

SOYBEANS	Expected	5%	-5%	15%	-15%
Price/Yield	50.0	52.5	47.5	57.5	42.5
$11.00	$50.00	$77.50	$22.50	$132.50	-$32.50
$10.30	$14.80	$40.54	-$10.94	$92.02	-$62.42
$10.00	$0.00	$25.00	-$25.00	$75.00	-$75.00
$9.00	-$50.00	-$27.50	-$72.50	$17.50	-$117.50
$8.00	-$100.00	-$80.00	-$120.00	-$40.00	-$160.00

'20-21 Corn Sales Plan				All 5 sales =	$129.80	Net Profit Per Acre
Bushels	Net Price	CZ20 Sale	(+) Spread	(+/-) Basis	(+) Prem	Exp. Del
				Best CASH Market =		

More times than not, farmers are rewarded with spread carries *and* basis appreciation when they sell crops before they are considered 'made'. Such combination regularly results in a higher average cash price than the nearby futures high for the crop year.

Our most successful clients have the most confidence in their production costs after they complete our **Input Sheet** and **Crop Marketing Plan.**

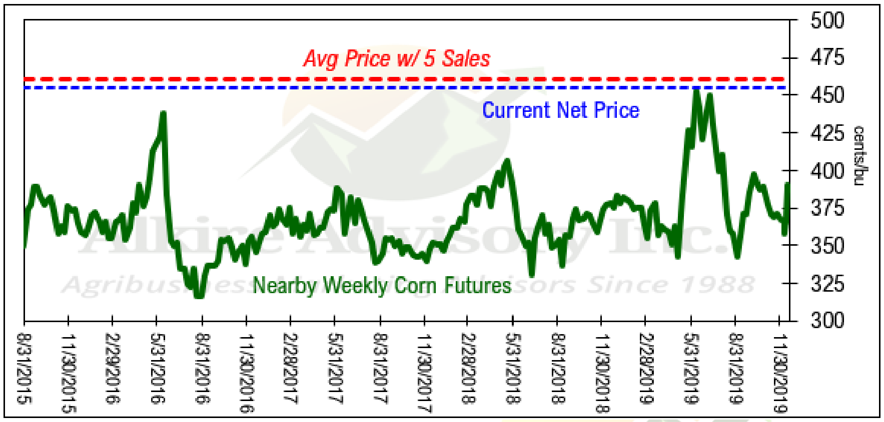
The **Crop Marketing Plan** calculates net profit or loss per acre of production sold at various prices and yield scenarios, as shown.

The **Sales Plan** includes our scale-up price goals, and conservative estimates of spread carries and basis for expected delivery periods.

This year, we added a Premium section to account for price-enhancing option strategies and specialty deals, as well as costs of call protection against current or expected sales.

Sales Execution **EXAMPLE**

'20-21 Corn Sales		22% Sold		70,000 Bushels Unsold		
Date	Bushels	Net Price	CZ20 Sale	(+) Spread	(+/-) Basis	(+) Prem
		$ -	$ -	$ -	$ -	$ -
		$ -	$ -	$ -	$ -	$ -
		$ -	$ -	$ -	$ -	$ -
		$ -	$ -	$ -	$ -	$ -
	20,000	$ 4.55			As of:	12/19/2019



Sales Execution, found on the second tab, is used to manually record sales – including futures prices, spread carries, basis and net option premium.

The average price with all five sales is plotted with a red line on a nearby futures chart found on the second tab, and is taken from the **Sales Plan** on the first tab. This **red line** compares your expected net farm price to nearby corn futures on a weekly basis.

Once sales are made and recorded in the **Sales Execution box**, your updated net hedge price is plotted with a **blue line** on the same chart.

For quick reference, the **Sales Execution box** reflects your **percent of expected production sold** as well as **production left to sell in bushels**.

The best ag market ideas and hedging strategies in the world mean nothing without a plan and execution.

What are your best crop marketing alternatives for 2020?

Your risk appetite is unique to you, but is something we can help you determine.

Can you manage a futures or options position that requires margin money?

Even though margin money flows both ways, some clients can handle such positions, and some cannot. Those who cannot, should sell with **cash contracts** and "back-stop" sales with affordable call options ahead of U.S. summer weather risk.

If you buy calls to protect a cash sale price, or in anticipation of a cash sale, this combination is called a **'synthetic put.'** The cash market sale locks in price without margin exposure, and the long call protects against a run-away market, which may occur under a U.S. summer drought. The long call requires a one-time payment and has no added margin call risk. Without a summer drought, odds are low an affordable call will make money.

We are fine with this because long calls give us the confidence to sell a higher percent of the crop than you would without them, and before you and the world know they are made. This is usually when the best sale opportunities occur.

Some marketers buy puts instead of creating a low-cost synthetic put. When prices are attractive enough to sell, puts can cost 5 to 10 times more than an out-of-the-money calls bought when they are cheap.

<u>Key Point</u>**: When you only protect against major price moves – i.e. real or imagined U.S. summer droughts – synthetic puts offer affordable and practical risk management.**

CASH MARKET ALTERNATIVES:

1. **Forward cash contract –** Locks in the net cash price, reduces futures price risk and basis risk. This is a good strategy when all components of net hedge price are attractive: futures price, basis and the futures spreads. Forward cash contracts are for a set delivery period, price and bushels with the buyer, and cannot be rolled.

2. **Basis Contract –** With a typical basis contract, a farmer delivers bushels to the buyer, and if the farmer believes futures will rally, can choose to only lock in basis and keep 100% of the futures price risk. These work fine if futures rally, but problems arise when price trends down and the farmer forgets about the basis contract. Rolling basis contracts in a carry market is unprofitable because basis widens equal to the spread carry when rolled.

3. **Hedge-To-Arrive (HTA) –** Just as the name implies, an HTA sets the futures contract price, bushels sold, but leaves basis open. Some grain companies offer delivery and the option to roll the HTA futures month into the future for a fee. <u>High</u> fees (2x to 10x more than using futures) and limited basis opportunities are two costly problems of HTAs, compared to using futures in your own account. **No farmer overpays two- to ten times for cash rent – why do it with marketing fees?**

   Buyers may not allow an HTA to be rolled to a future delivery month and they often limit the number of rolls. Grain companies do not allow farmers to roll HTAs to other crop years, even though there are no rules against it.

   Cash contracts are not governed by the same rules of the futures industry, which can be a problem because **grain buyers can and do change terms of an HTA agreement in their favor at the farmer's expense.**

   A buyer who has signed an HTA agreement with a farmer has minimal incentive to negotiate basis in good faith, when compared to bushels he must originate. In addition, most buyers will not allow delivery to the best market in your area, which is typically an ethanol plant, processor or large feed operation.

4. **Delayed Price (DP) –** A better term may be, 'Delayed Pain.' Under this cash contract, title passes to the buyer upon delivery of grain. If the buyer files for bankruptcy, the farmer receives 98% of the contract value from the state indemnity department. Some feeding

operations exclude themselves from their state's indemnity program, in which a bankruptcy of the buyer could be costly to the farmer.

Grain buyers like to offer 'free' DP when basis peaks. When this happens, buyers bet basis will not appreciate more than the value of money. When basis is trending down, the farmer loses each day he waits to price. Like basis contracts, DPs are dangerous because farmers may 'forget' they have the contract, and have a strong seasonal tendency to set price near cash market lows at the end of each crop year when the contract runs out.

5. **Price Plus –** The grain buyer adds a premium to the spot cash price to encourage the farmer to sell. A primary issue is the farmer must agree to sell the same number of old or new crop bushels again if futures close above a certain price on a certain date. This can be attractive for farmers who missed a good selling opportunity. The premium added to the cash price improves the sale, but restricts the number of bushels they can sell in the future. The risk here is if the farmer forgets about his potential obligation to sell more bushels, and when price rallies, the farmer is reluctant to sell more because of this commitment, or has sold more than expected or produce.

HTA versus using Futures in own account

Hedge-to-Arrive (HTA):

- Fee: 2 cents, up to 10 cents new crop.
- **Delivery location set.**
- **Delivery period usually set.** Does not allow rolling to new crop if crop is not produced. Cancellation fees of 7 to 15 cents, plus market difference. Market gain?
- **Basis negotiation: limited, buyer has bushels locked up** – it is an **origination tool** for the buyer.
- **Margin Money:** Typically not required, but could be asked for in extreme market move. ***Definitely do not get to use hedge profits prior to delivery.***

Futures:

- Fee: about 1 cent, same for new crop.
- Unlimited delivery locations.
- Delivery period not set – may roll to new crop if over sell in a carry market.
- **Basis negotiation: unlimited, move to highest bidder.**
- Hedge liquidation: "Exchange for Physical" means **ZERO hedge slippage**.
- **Margin Money: Required, but flows both ways –** ***hedge profits can be used prior to cash delivery.***

Pricing with futures provides maximum basis negotiating power over a grain buyer & opportunity for most success when dealing in cash market.

There are many strategies to sell a crop, but low-cost synthetic put options are tough to beat.

A synthetic put option strategy involves an outright futures sale (or cash contract sale), and purchase of an out-of-the-money call option above the sale price.

If there is no drought, the December to March and March to July spreads trade at a carry. When we add the carry to the sale price – captured from rolling a short futures position – hedged bushels have an excellent opportunity to beat the nearby futures high for the crop year, post-harvest.

The sale of an out-of-the-money call with a strike price plus premium can potentially create a superior futures sale price if the option expires in-the-money. If the option expires worthless, collected premium enhances the outright futures price. This is more attractive when the extreme up-side price risk is covered with an affordable call.

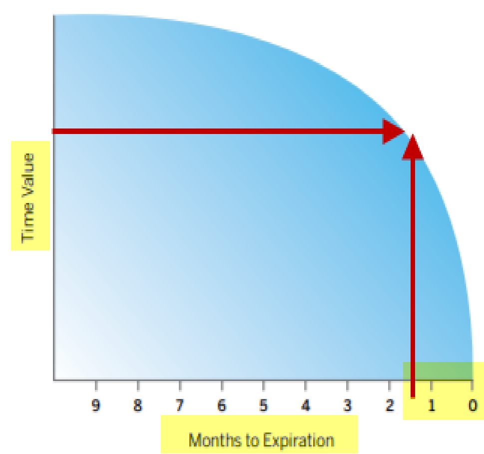


Chart: The time value of an option decays the quickest 40 to 30 days prior to expiration.

We typically <u>sell</u> calls against expected production when we have a double backstop with unsold bushels for the current crop year and the next crop year. If futures rally, one can take full advantage of the rally by selling the current crop at a higher price. Selling a call is a marginable position.

If the calls are later exercised, you sell more at the strike price plus premium collected – and eventually move the hedge to the next crop year. In a full carry market, the price increases when rolled. The risk is in a drought year, the spreads invert and reduce the hedge price if rolled.

Futures and options are highly regulated by the CME, NFA and clearing firms, which make the rules and regulations **Alkire Advisory** follows as an Introducing Broker. Cash contracts have no such regulations.

Advantages of using futures contracts:

- Lowest fees: about 1 cent, same for new crop.
- Unlimited delivery locations.
- Delivery period not set – may roll to new crop if over sell in a carry market.
- **Basis negotiation: unlimited, move to highest bidder.**
- Hedge liquidation: "Exchange for Physical" means **ZERO hedge slippage**.
- **Margin Money: Required, but flows both ways – *<u>hedge profits can be used prior to cash delivery.</u>***

Using futures to sell allows you to maintain negotiating power over a grain buyer, which gives you the best opportunity to be successful in the cash market.

OTC-backed cash contracts are the Wild-West of cash grain merchandising. Oftentimes, they can be confused with a Las Vegas-type game of chance, because they do not help manage risk.

OTC-type contracts: "Accumulator," "Price-plus," or any number of strategies (no limits) makes it *more* **difficult to protect, manage and lock-in farm profits** because a farmer never knows how many bushels he has sold for what price. Additionally, OTCs lack liquidity and transparency, which is never good for reducing costs to consumers (few market makers). OTC-type cash contracts are generally the **highest profit margin contract grain companies use to make money off farmers.**

Sound risk management defines bushels sold, at a known price, for later delivery. OTC-style sales do not do this.

We hope this review of our updated **Crop Marketing Plan**, and marketing strategies helps you better understand how to manage profit margin risk. Most importantly, help you stay focused on the important goal: **Make Money Farming!**

Please call, email or text if you have any questions.

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