Floored Averages – Serving Borrowers and Lenders in Difficult Times

by:
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Thanks to productivity gains and cooperative weather, prices received by domestic grain and oilseed producers continue to be disappointing. With signs of weakening economies around the world, farmers need new tools to help market grain in a manner that is financially safe as well as profitable. The Floored Average contract was developed to serve the producers' marketing needs and has proven to be beneficial to farm lenders as well.

Producers and farm lenders mutually benefit from marketing programs that guarantee a minimum price on crops. The record is mixed on conventional marketing programs largely because pricing decisions are discretionary, and these programs usually do not provide a minimum guaranteed price. Statistical evidence demonstrating the difficulty of beating the average market price has been compiled by Darrel Good and Scott Irwin, AgMAS Research Project, University of Illinois Champaign-Urbana. The evidence demonstrates that the experts usually do not exceed the market average.

For the farmer, the statistical evidence suggests that paying for discretionary marketing advice and/or execution doesn't always pay off. For lenders, the situation is even worse. While excluded from the benefits of successful discretionary advice, lenders remain subject to risk when discretionary advice or execution fails to secure a sufficient price. Therefore, lenders have a special interest in compelling their borrowers to employ non-discretionary marketing programs that guarantee a minimum price. The statistical evidence, combined with the one-sided risk borne by lenders, highlights the value of the Floored Average contract. Clearly, it is a grain marketing alternative that serves the

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mutual interest of borrowers and lenders.

The Floored Average contract is a marketing alternative that, in exchange for a service charge, guarantees the farmer the higher of either a fixed floor price or the average price observed during a predefined time frame. Under no condition can the floor price be reduced or the averaging period changed in this contract. Further, there is no discretion in market timing while the cost and minimum possible price are known in advance.

Simply put, the Floored Average reduces the peril of declining prices while maintaining participation in potential price gains for the farmer. Retaining the opportunity for price gains, in combination with a guaranteed floor and cost efficiency, are the reasons the Floored Average has been so successful.

Other marketing alternatives share some attributes of the Floored Average, but none provide all the advantages. Further, the disadvantages of the various alternatives (such as discretionary market timing, lack of a guaranteed minimum, higher costs, and the possibility that the farmer surrender participation in potential price gains) makes each of these choices relatively unattractive to either the farmer or lender, and in many cases, both. The following types of contracts broadly describe currently available crop marketing alternatives.

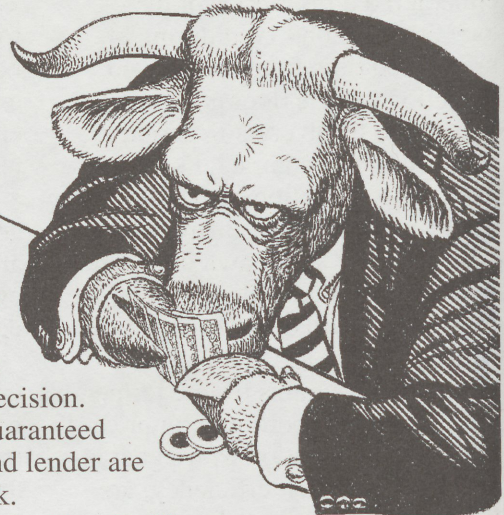
- Doing nothing and hoping for a satisfactory price at harvest
- Trying to time the market and sell "when prices look good"
- Hiring a marketing advisor-manager to time the market
- Selling on a minimum price contract
- Selling on a simple average price contract

Clearly, doing nothing and hoping for a satisfactory price at harvest is risky for both the farmer and, by extension, the lender. While sufficient net worth may overcome the price risk in a given year, or even for a few years, this is not an advisable way to secure revenue and may be unsustainable for even the wealthiest farmers in a persistent bear market.

Trying to time the market taxes both the farmer's time and nerves because it requires active monitoring of the market and ongoing decision making. Further, as the statistical data from Good and Irwin indicates, it is difficult for even the professionals to beat the average price. Additionally, because there is no minimum guarantee, the risk of such a strategy is substantial. Finally, market-timing strategies frequently necessitate that the farmer incurs storage costs.

Storage costs may be direct, but they also may be indirect in the form of maintenance costs and quality risks. These indirect costs are necessarily imposed on the farmer who uses on-farm storage. In effect, storage normally guarantees a higher cost to the farmer, while providing only the possibility of price improvement through market timing.

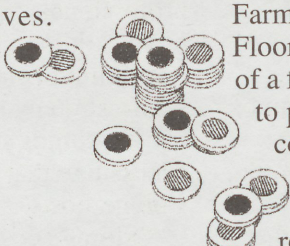
Hiring a marketing advisor-manager to time the market may relieve the farmer of some time burden. However, the farmer still bears the psychological burden of potentially unlimited downside price risk. Perhaps, more importantly, the potential financial burden due to the lack of a contractual minimum price is not alleviated for either the farmer or the lender. Notably, hiring an advisor-manager to time the market does not alleviate the potential storage cost burden borne by the farmer.



Selling on a minimum price contract relieves the burden of missing a floor price, but at a cost higher than the Floored Average alternative. Or, if the cost is not higher than the Floored Average, the guaranteed minimum is lower. Additionally, a minimum price contract requires that the farmer retain the burden of a pricing decision.

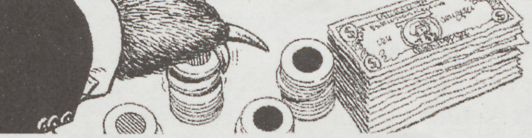
Finally, selling on a simple average price contract retains some upside price opportunity for the farmer, and eliminates the time burden of a pricing decision. However, this alternative has no guaranteed minimum. Therefore, the farmer and lender are exposed to significant downside risk.

The Floored Average contract provides significant advantages to both farmers and lenders that are not provided by other crop marketing alternatives.



Farmers marketing grain under a Floored Average enjoy the security of a floor price and the opportunity to participate if prices rise. As a consequence of the floor, lenders can be more confident in the revenue projections they review.

Having recognized these advantages, lenders have encouraged borrowers to consider the Floored Average. Further, other lenders have expanded outstanding loans through more competitive rates or increased total credit available to farmers who use the Floored Average. Given the ongoing difficulty in agriculture, we anticipate continuing growth in the adoption rate of the Floored Average based on the mutual benefit enjoyed by both farmers and lenders.



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