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Co-ops Managing Through Low Margins

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By **KERI L. JACOBS***

THE current environment for Midwest firms marketing corn and soybeans presents challenges for identifying margin opportunities. Rising grain inventories, a stable basis and hesitant selling by producers continue to depress overall grain margins.

Agricultural retailers, despite being faced with similar optics on the producer side — declining average net farm incomes, low commodity prices and tighter lending situations for some — are faring a bit better.

Quarterly data from agricultural cooperatives in Iowa illustrate the trends in margins that reflect these factors and are likely affecting grain merchandisers and agricultural retailers (Figure 1). For this group, average year-over-year grain product margins reported in the first quarter of 2016 came in at 1.4%, a substantial drop from the prior quarter's 5% product margin.

Yet, this lower margin does not suggest a significant deviation from the prior or five-year average for the first quarter and is not surprising, given the lack of producer interest in forward selling.

The bright spot remains the stability of agronomy product margins and service revenues, both of which appear robust.

Margin as a percentage of sales is only half of the story. In general, grain and farm supply firms — many of which have feed and energy enterprises as well — have seen declining sales dollars generated per dollar of net fixed assets (Figure 2). While this is due partly to the significant investments made in fixed assets at all levels of the supply chain, the bigger issues are declining sales dollars in absolute terms and falling local income.

Cooperatives' story differs from other grain and farm supply companies. In addition to the income they make from their local operations ("local income"), local agricultural cooperatives receive patronage from their regional partners — e.g., AGP, CoBank, CHS and Land O'Lakes — which is included in the total income calculation.

As illustrated in Figure 2, profitability at the regional level fills in the income slack local cooperatives experience. In Iowa, for example, cooperatives recorded about 1.7 cents of patronage from regional partners for every dollar of sales in the first quarter of 2016, compared with the prior five-year average of about 1.0 cent per sales dollar.

Many cooperatives emerged from the 2012-13 period of high corn prices with strong balance sheets, particularly for working capital, and have been able to maintain that strength despite the recent margin environment (Table). The data suggest that cooperatives built significant working capital but are beginning to show signs of a trailing working capital-to-sales ratio. For most firms with a mix of grain and agronomy, a ratio in the 3-4% range is considered acceptable, with higher values indicating reserve strength.

As noted, sales are in a period of decline, and that shows in the slower sales-to-local equity measure. Long-term borrowing continues to be well below threshold leverage levels, and cooperatives' capacity to service debt ensures that additional borrowing is unlikely to be a hurdle in the coming quarters.

Finally, most agricultural retailers are keeping an eye on credit challenges that may arise as their customers face tougher economic conditions. Current accounts receivable measures, including collection days, do not yet show signs of customer account issues.

Looking ahead, Midwest grain and farm supply companies will undoubtedly continue to face challenges managing grain margins and may begin to feel the effects of customer accounts receivable issues if production agriculture revenues and incomes continue to drop.

To date, data from Iowa suggest that cooperatives have strong balance sheets and are taking steps to help their member-producers manage through this period. ■

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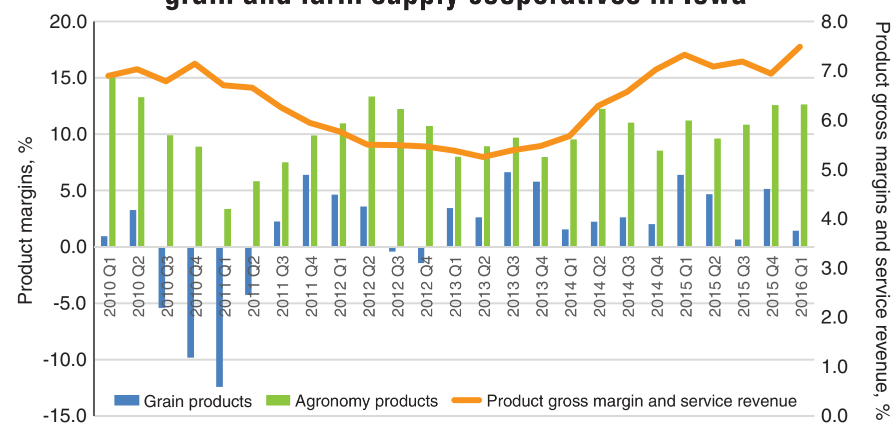
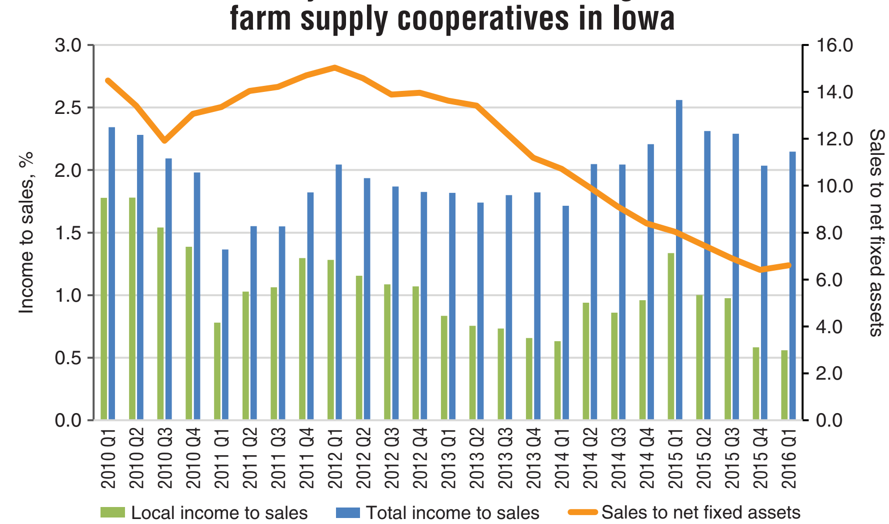
1. Quarterly margins and service revenue for grain and farm supply cooperatives in Iowa



2. Quarterly income and sales for grain and farm supply cooperatives in Iowa



Source for Figures: CoMetrics, average of 31 grain and farm supply cooperatives in Iowa.

Key financial indicators, Iowa grain and farm supply cooperatives

Financial indicators	5-year avg.	2016 Q1 YTD
Working capital to sales (%)	5.3	5.4
Sales to local equity	10.82	6.42
Long-term debt to net fixed assets (%)	53.9	37.1
Long-term debt to local equity (%)	51.7	39.2
Accounts receivable collection days	43.18	18.97

Source: CoMetrics, average of 31 grain and farm supply cooperatives in Iowa.