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Ag Retailers – Cyclical Challenges Ahead

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Key Points:

- *Ag retailers operate as middlemen in selling a wide variety of crop inputs to growers. Consequently, when growers are doing well, so are the ag retailers; but when growers are doing poorly, so are the ag retailers. It's the latter scenario that prevails today during the current down-phase of the commodity cycle.*
- *As agricultural commodity prices have fallen in recent years, so have growers' incomes. The latter have fallen more than 50 percent from 2013 to today. Meanwhile, farmers' debt-to-income ratio is on the rise and approaching levels not seen since the farm crisis of the 1980s.*
- *Farmers will remain reluctant to pre-pay for inputs, leaving suppliers guessing what demand will be. Matching supply with demand for fall and spring fertilizer applications will be a moving target for ag retailers.*
- *Farmers will also be keen on cutting crop protection or chemical applications, such as eliminating seed treatments or fungicide applications unless treatment has a proven economic return.*
- *With fertilizer prices expected to continue weakening through 2016 and into 2017, ag retailers are intent on emptying their warehouses of all product by the end of the current growing season.*
- *Greater industry alignment between ag retailers and wholesalers is anticipated in the future, especially as ag retailers try to position against a possible future where wholesalers sell product directly to large farmers, thus cutting out the middlemen.*
- *Facing lower margins and heightened risk, ag retailers will branch out to provide new value-added services, including soil testing, precision ag technology tied to chemical, seed, and fertilizer applications, and helping growers decipher where best to invest dollars on inputs.*
- *Ag retailers are apprehensive about recently announced (potential) mergers of major agribusiness companies, particularly in the seed and crop protection industries. They foresee declining competition in the marketplace, a potential reduction of rebates on volume product purchases, and wholesalers bypassing ag retailers and selling direct to farmers.*

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Ag Retailers Today – Risk Rising

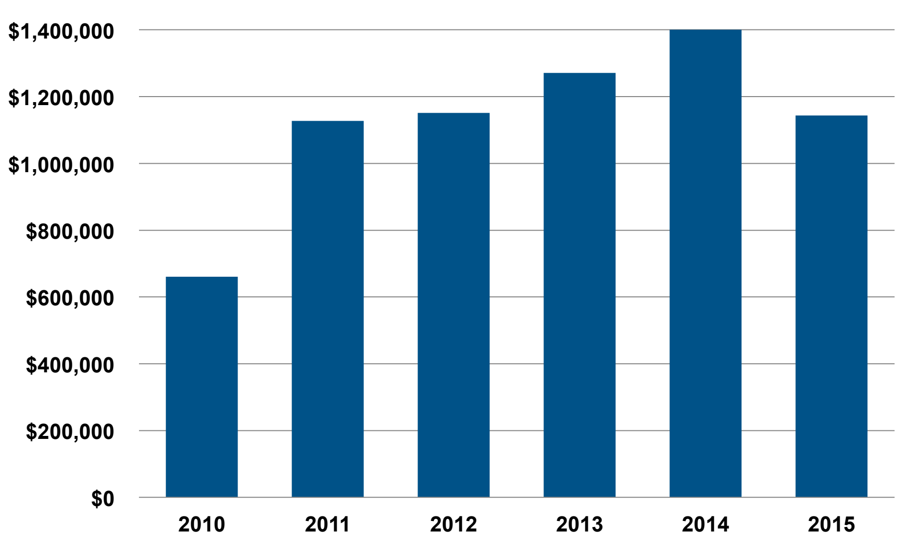
After an extended run of impressive financial performances posted year after year, ag retailers in the U.S. are scrambling to adjust to the rough economic patch accompanying the down-phase of the current ag commodity cycle – one that entails low agricultural commodity prices, compressed farm incomes, greater counterparty risks as some farmers' cash flows tighten, and a dizzying array of high profile mergers and acquisitions across the industry. Farmers are tightening the tourniquet on cash outflow by cutting or delaying input costs, while mergers and acquisitions of major seed, chemical and fertilizer companies leave ag retailers in a bind of tighter margins and higher risk.

Ag retailers today are getting squeezed, as reflected in their weakening profitability. Based on an analysis of approximately 200 of CoBank's customers that operate strictly in the farm supply industry, net operating profits last year shrank 18.4 percent due to rising operating expenses and higher depreciation costs. *(See Exhibit 1.)* The higher costs follow years of investment into infrastructure and new facilities – all necessary upgrades that nonetheless now hurt the bottom line.

Meanwhile, total accounts receivable continue to march upward, having posted an eleven percent gain for 2015, with further increases anticipated in the coming one or two years. *(See Exhibit 2.)* In prior years, the retail prices of crop inputs climbed more or less in synch with the increases in commodity prices, so the growth in accounts receivable reflected a strengthening bottom line for farmers as well as ag retailers. This time around, however, commodity prices have fallen much more than crop input prices, so the current growth in accounts receivable represents a warning sign of farmers' weakening profits and eroding credit quality.

As accounts receivable continue expanding, there are no glaring danger signs of industrywide credit risk, thanks to several prior years of strong and growing profits. Nonetheless, ag retailers will be keeping a watchful eye on their customers as the industry readjusts through the current cyclical downturn affecting all reaches of the commodity spectrum.

Exhibit 1: Net Operating Profit
CoBank Farm Supply Customers, 2010-2015



Source: CoBank ACB.

Customer Risk

Anticipating that farmers' debt-to-income levels will continue to ratchet higher, ag retailers are bracing for greater losses in agronomy sales and margins, and further deterioration in their customers' creditworthiness. *(See Exhibit 3.)* Some ag retailers have noted that they are carrying receivables on their books for input purchases made by farmers in 2014, thereby testing long-held relationships with their ag retailers. One ag retailer CFO commented recently about a farmer customer with a long history of timely payments, "He wasn't a [credit] risk until he was." Today, even customers with a strong history of being good and loyal customers will be subject to greater scrutiny. Of particular concern

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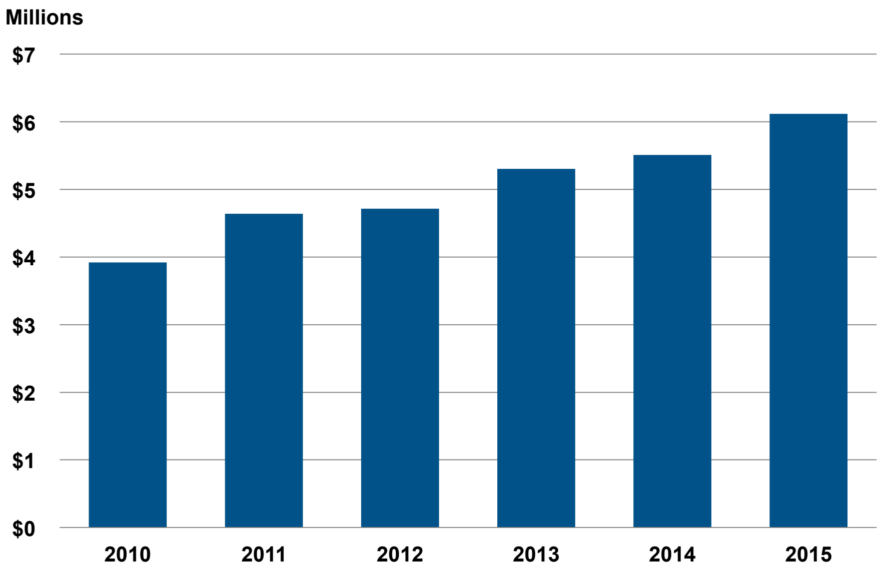
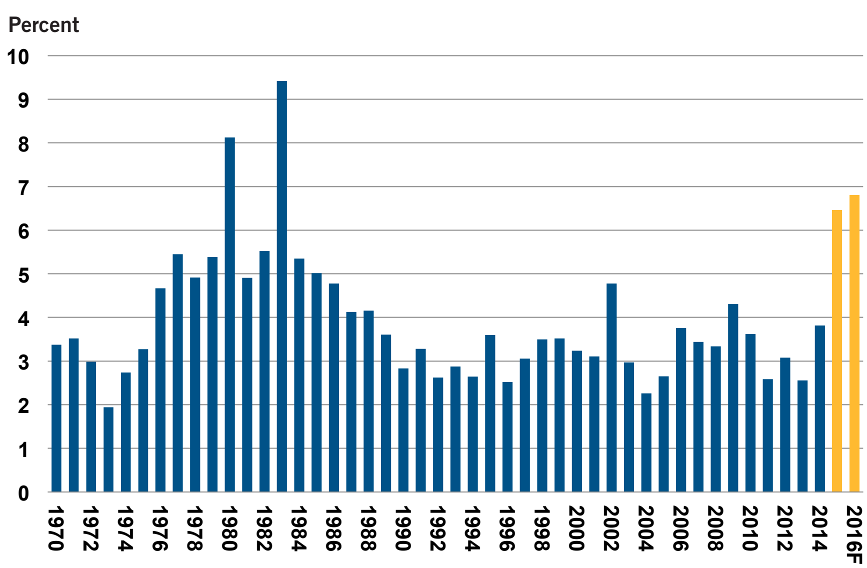
Exhibit 2: Accounts/Notes Receivable
CoBank Farm Supply Customers, 2010-2015



Source: CoBank ACB.

Exhibit 3: U.S. Farm Sector Debt-to-Income Ratio



Source: USDA-ERS.

will be producers with high leverage, limited equity, or producers locked into high cash rents and high land or machinery payments.

Farmers, having had to run down their cash reserves in the past year or two while also stretching their lines of credit, will likely remain keen on cutting costs and reluctant to pre-pay for inputs, leaving suppliers guessing what demand will be. Some farmers will also be more apt to take on greater risk by delaying fertilizer purchases in hopes of prices continuing to decline. Fertilizer applications will be the wild card for ag retailers as they try to match supply with a less-certain demand as fertilizer prices continue on a downtrend.

Ag retailers will also likely face additional competitive pressures. With farmers becoming ultra-sensitive on cutting their costs, ag retailers face a heightened risk of losing customers as farmers become more willing to upset long-term relationships in favor of seeking better deals. This trend will likely grow as well-capitalized farmers continue to look for opportunities to expand their acreage (and geographical range), while other farmers laboring under greater financial stress exit the industry. As larger farmers expand, they control an increasing share of total business in the area along with access to a greater number of local retailers and the ability to source directly from wholesale suppliers.

Fertilizer

Fertilizer sales continue to be the predominant revenue driver for ag retailers. The CropLife 100 report showed that among the country's largest retail organizations, fertilizer accounted for 48 percent of total revenue in 2015, according to the industry survey. However, recent efforts to maintain positive margins from fertilizer sales amidst a declining market environment have kept retailers on edge, with many now operating "hand-to-mouth" with regard to supply. Retailers are doing what they can to avoid a repeat

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of last fall, when they purchased fertilizer in advance of post-harvest application, only to be left holding inventory that had lost significant value by the spring.

The current forecast for fertilizer prices calls for continued price declines through 2016 and into 2017 as commodity markets remain under pressure from abundant crop supplies both globally and in the U.S. – creating a tricky market for fertilizer dealers to navigate in the months ahead. *(See Exhibit 4.)* According to Blue, Johnson and Associates Inc., average anhydrous ammonia prices in the Corn Belt are expected to drift lower into the fall and winter to $390/ton, down from the April 2016 high of $510/ton. For 2017, the Corn Belt price for ammonia is forecast to average $395, down from the 2016 expected average of $430/ton and last year's average price of $558/ton. The strong U.S. dollar, meanwhile, will likely support continued fertilizer imports while abundant Chinese exports will keep global fertilizer supplies high. Amidst this environment, ag retailers will need to monitor and manage their fertilizer exposure very carefully as they attempt to empty their warehouses by the end of the season. With farm profits still in retreat, growers likely will continue playing cat-and-mouse with ag retailers to hold out for lower prices.

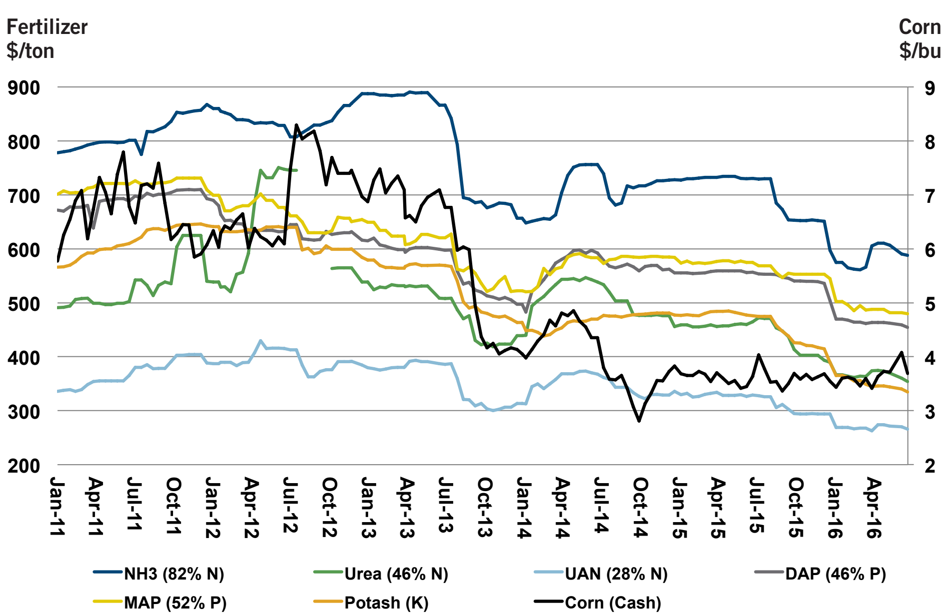
Given depressed demand and ample supply, fertilizer margins will likely remain on the defensive for ag retailers through 2016 and beyond. To help control costs and reduce price risk, ag retailers are looking to partner with wholesalers by offering them warehouse space. Wholesalers, in return, offer deferred payments on the inventory stored in those warehouses. Such strategic alliances benefit both parties by reducing supply and price risk.

Greater industry alignment between ag retailers and wholesalers is anticipated in the future, especially as ag retailers face the increasing threat of direct-to-farmer sales. Progressive ag retailers, meanwhile, will continue to offer more precision ag services to differentiate themselves from the competition and to create more value for farmer customers.

Weather is now top-of-mind for most U.S. growers. The El Niño pattern has ended, and according to the National Oceanic and Atmospheric Administration's (NOAA) climate prediction center, La Niña is favored to develop in the Northern Hemisphere during late summer with a 75 percent chance that it will be in place by the fall. La Niña usually delivers warm and dry weather conditions to the U.S. Midwest. For ag retailers, this would be a most welcome change from last fall when chilly, wet weather disrupted fall fertilizer applications and severely crimped sales, forcing them to carry inventory into the spring and subjecting them to heightened price risk.

The risk of government regulation in the fertilizer space, meanwhile, is an ever-present concern. New on the horizon are the plans for safety regulations from the Occupational Safety and Health

Exhibit 4: Central Illinois Corn & Fertilizer Prices



Source: USDA-AMS.

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> *With farm profits still in retreat, growers likely will continue playing cat-and-mouse with ag retailers to hold out for lower prices.*

Administration (OSHA) regarding storage of anhydrous ammonia. Ag retailers previously were exempt from the Process Safety Management for Highly Hazardous Chemicals (PSM) requirements. However, in July 2015, OSHA announced that it would lift the exemption for ag retailers starting in October 2016, requiring ag retailers either to significantly increase facility investment to be able to comply with the PSM rules or to eliminate storage of the product all together, with both options expected to result in higher fertilizer prices paid by farmers. Ag retailers with the resources to build facilities, meanwhile, will be better equipped to comply with the higher regulatory burden. Legislation was introduced in Congress via the FARM Act to address OSHA's decision to remove the exemption for retailers from PSM with a court decision pending.

Seed and Chemical Inputs

A tsunami of consolidation is sweeping across the seed and crop protection industries. Ag retailers, caught by surprise, have been thrust into a maelstrom of great uncertainty – uncertainty on the one hand about product offerings and prices and uncertainty on the other hand about farmers' financial footing and willingness to shop for products.

Several potential mergers have been announced recently by Dow Chemical Co. and DuPont Co., China National Chemical Corp (ChemChina) and Syngenta, and Bayer is actively pursuing a takeover of Monsanto. Ag retailers are concerned that these mergers, if approved and realized, will greatly increase concentration while reducing competition within the crop input space. Seed and chemical retailers are particularly worried about the distinct possibility of losing volume discounts or rebates for volume purchases. Some retailers also wonder whether international mergers, such as ChemChina and Syngenta, would result in roll-outs of new technology being limited only to Chinese or Asian producers and not marketed in the U.S.

But bigger could turn out to be better in some respects for ag retailers. For example, larger crop input companies may be able to generate more new-product offerings that create added value and new revenue streams for ag retailers. Faster approval of new seed or crop protection chemistries could also result from international mergers.

Regulators in the U.S. and abroad, though, will be concerned with the steep reduction of competition and potential loss of innovation and research industrywide that could leave ag retailers and farmers with fewer purchasing options. Mergers could be blocked, or companies could be required to divest assets to maintain a competitive market environment. Additionally, national security officials in the U.S. are also weighing concerns of internationally owned chemical companies that have plants located near strategic military sites.

In the intermediate term, ag retailers are getting squeezed by declining margins on seed and crop protection products as farmers trim their crop production costs and hunt for bargains. As growers' financial stress intensifies through 2016 and into 2017, they will be more inclined to reduce chemical purchases by cutting application rates or eliminating applications altogether. For instance, farmers may hold-off on foliar fungicide treatments or seed treatments unless absolutely warranted. Farmers also will become keener on field scouting and applying chemical treatments only in situations where a pest problem exceeds an economic threshold level. Looking ahead into 2017, crops that are cheaper on seed and inputs will be seen as a less risky option and less financially burdensome to the farmer.

Conclusion

As fertilizer prices continue trending downward, the greatest challenge for ag retailers will be managing inventory to synch with demand. Meanwhile, retailers will also keep a wary eye on credit lines extended to

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farmers who are under financial stress. As farmers' debt loads increase, retailers will likely experience accounts receivable "creep" as producers struggle with declining working capital.

Some companies could offer convenience credit to help farmers through the growing season. However, in doing so, ag retailers would shoulder a higher risk of potential write-offs. For instance, for every dollar of product written off, a retailer would have to sell $50 of product at a 2 percent margin to recover the write-off. In the tighter-margin, higher-risk environment of low and declining farm revenues, ag retailers will face the slippery slope of testing long-held customer relationships against declining creditworthiness.

With commodity prices expected to remain at levels sharply below the record highs achieved in recent years, financial stress across the ag retailer space is expected to grow in the next 12-18 months as margins tighten, hastening the trend toward more consolidation across the industry. Lower margins and increased price risk, particularly with fertilizer, will impel retailers to seek out value-added services in a more competitive environment. More focus will be given to services like soil testing, precision ag technology matched with chemical, seed, and fertilizer applications, and helping growers decipher where to invest dollars on inputs. Some ag retailers are working closely with customers to match the farmers' grain sales with their crop input purchases. Low margins for farmers are anticipated through the remainder of 2016 and 2017, but with farm production costs gradually realigning with low commodity prices.

Mergers and acquisitions across the entire supply chain from manufacturers to wholesalers and retailers will become increasingly likely in an effort to reduce supply chain costs and broaden the reach to more customers. As the industry experiences painful realignment through the current cyclical phase of low commodity prices and compressed farm incomes, cost-efficient and well-aligned ag retailers will emerge on ever stronger footing – and will be positioned to reap huge rewards long term.

CoBank's Knowledge Exchange Division welcomes readers' comments and suggestions. Please send them to KEDRESEARCH@cobank.com.

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