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March 2023

Ag Retailers Prepare to Navigate 3 Emerging Risks

Kenneth Scott Zuckerberg
Lead Economist,
Grain and Farm Supply

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Key Points:

- Ag retailers can still expect profitability in 2023 after setting records in 2022, but they face an emerging set of risks that could depress profit margins and challenge traditional business models in the years ahead.
- Setting the stage is the shifting grain market. More favorable weather patterns (the end of the La Niña weather effect) and increasing planted acres should drive higher grain production – leading to what we believe will be a downturn in the crop cycle (i.e., lower grain prices) during 2024 or shortly thereafter.
- From a big picture perspective, farm supply cooperatives will see challenges in five risk categories – macro, financial, operational, business model, and regulatory – but must navigate three emerging risks in particular.
- Over the next five years, ag retailers will need to get a handle on changing customer needs, lower expected industry working capital, and rising property-casualty insurance costs.
- Although there is no silver bullet solution for managing these three risks, ag retailers have options and opportunities including selling more value-based alternative products (biologicals, specialty nutrients) to address changing consumer needs, adopting digital technologies, and accessing alternative risk transfer mechanisms (such as self-funded insurance captive arrangements) in addition to traditional property-casualty insurance solutions.

Overview

Grain and farm supply cooperatives have delivered tremendous value to their customers over the past three years, a period that featured extreme volatility in prices for grain, fertilizer and energy as well as unpredictable economic activity stemming from COVID and the Russia/Ukraine conflict. While grain prices and farmer income should remain favorable during 2023, we believe there is a strong chance that the crop cycle will turn down in 2024 or soon thereafter.

Our reasoning is based on forecasts of improved drought conditions across much of the central U.S.,[1] which will help drive more grain production. Should an economic slowdown occur (either in domestically or abroad), it will slow demand for feed and fuel grains, adding further downward pressure on the crop cycle.

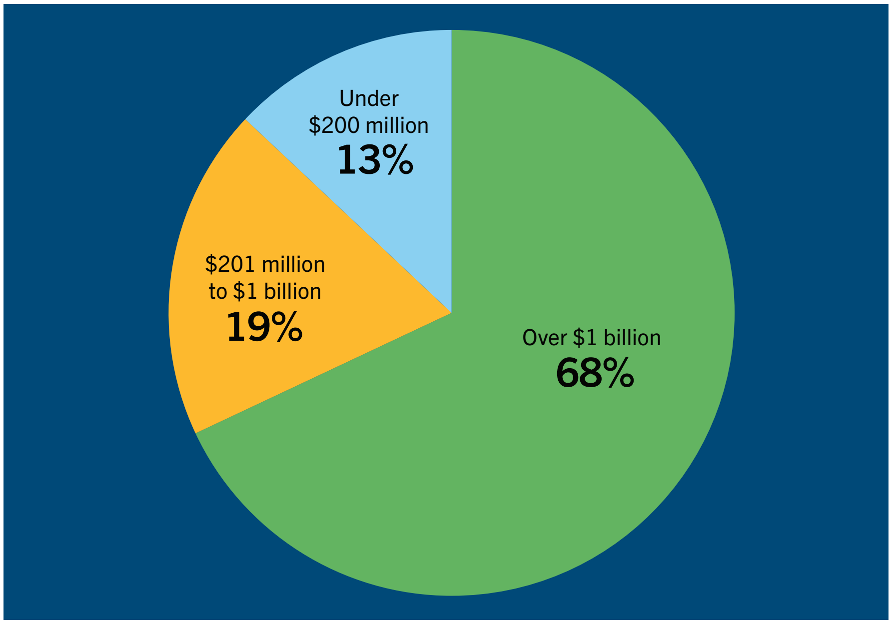
Once a downturn is apparent, agriculture cooperatives will then need to come to terms with a variety of other risks that will depress net income. Some of these include rising costs of property insurance, as well as higher borrowing costs to fund necessary capital expenditures for infrastructure to support the U.S. grain industry's transition from exports to biofuels processing.

Industry Structure

From the customer perspective, ag retailers serve four categories of U.S. farmers and ranchers: large-scale (46.0% of total production), mid-size (20.2%), small-scale (20.4%) and non-family (13.4%). Our customers tell us that large-scale and small-scale producers, which account for nearly 67% of grain production, are well-served by farm supply cooperatives and independent ag retailers. The issue – as we will describe later – is that the remaining 33% of producers are increasingly seeking more products and services than traditional farm supply cooperatives can offer.

On the sellers' side, 100 retailers account the majority of industry revenues and are split into three groups. The first tier includes seven companies with $1 billion or more of revenue, the second tier includes 22 companies with revenues between $201 million and $1 billion, while the third tier consists of 71 companies with sales of $200 million or less[2] *(Exhibit 1).* Market share is even more concentrated by major product

EXHIBIT 1: CropLife Top 100 Ag Retailers by Revenue Tier



Source: Meister Media, CropLife Top 100 – 2022 Rankings

EXHIBIT 2: Leading Ag Retailers Ranked by Major Product Sold

	Fertilizer	Crop Protection	Seed
Total Combined Sales of Top 10	$16.8 billion	$11.3 billion	$3.9 billion
Market Share of Top 10	72%	75%	78%
Top 10 Companies by Sales			
1	Nutrien	Nutrien	Nutrien
2	Helena	Helena	Helena
3	GROMARK	Simplot	GROMARK
4	Simplot	GROMARK	Simplot
5	Greenpoint Ag	Greenpoint Ag	CHS
6	CHS	Wilbur-Ellis	Wilbur-Ellis
7	Wilbur-Ellis	CHS	Hefty Seed
8	MFA	Hefty Seed	Agtegra
9	Co-Alliance	Agtegra	MFA
10	Agtegra	Co-Alliance	Co-Alliance

Source: Meister Media, CropLife Top 100 – 2022 Rankings

Important Note: Land O'Lakes' Winfield Division is NOT included in the CropLife 100 list of retailers because it is a considered a wholesaler which buys and subsequently resells crop inputs to its member cooperatives which in turn resell to farmer customers.

EXHIBIT 3: Categorical Risks Facing U.S. Agriculture

Category	What's Ahead
Macro Risk	• Volatile energy and fertilizer prices as the Black Seas conflict endures • Political / business interruption risk with China as a trading partner which could wreak havoc for grain, protein, energy and input (fertilizer and crop chemicals) markets • Higher prices for basic materials and semi-conductor chips as the United States on-shores manufacturing to reduce reliance on Asia
Financial Risk	• Higher borrowing costs as benchmark interest rates rise to and stay above 5% (vs. <1% a year ago) • Rising costs of business property-casualty insurance coverages and in certain regions, limited availability of property coverage due to three consecutive years of above-average losses • Significant need for capital investments in new infrastructure and upgraded enterprise technology
Operational Risk	• Labor shortages, wage inflation, high employee turnover, labor mismatches • Cyber-risk
Business Model Risk	• Lower than average levels of farmer working capital during the current upcycle imply that growers will cut back more dramatically in certain input purchases during the next downturn • Changing farmer preferences for precision tools and technology to respond to consumer and investor-driven sustainability / traceability initiatives • Growing demand for carbon monetization and ESG compliance advice • Need for new investment in grain cooperatives' infrastructure as domestic grain markets transition from an export orientation to a biofuels processing orientation
Regulatory Risk	• Regulatory restrictions on the use of pesticides (such as dicamba) could pressure sales of traditional crop protection products • Lack of effective bipartisan immigration policy continues to negatively impact agribusiness from a labor availability and planning perspective.

Source: CoBank

category, with the 10 largest players accounting for 72% of fertilizer sales, 75% of crop protection sales, and 78% of seed sales *(Exhibit 2).*

Emerging Risks

The U.S. agriculture industry did not miss a beat during the COVID pandemic with farm income reaching an all-time record during 2022. Unfortunately, categorical risks in the post-pandemic world are growing *(Exhibit 3).*

From these broad categories of risk – macro, financial, operational, business model and regulatory – we see three emerging risks that are not as widely discussed or considered as the others. We also see these specific risks as significant, as they have the potential to transform the ag retail sector.

Emerging Risk #1: Changing Grower Needs

An emerging body of research[3] suggests that modern farmers want more from input sellers than they are receiving. Our customers tell us that more and more farmers want to evaluate, order, and manage input purchases electronically without contact with an actual salesperson. Direct purchasing is prevalent in virtually every consumer product category and is increasingly the way businesses purchase materials, products, and services. The key point here is that if the customer is demanding something different, the input seller needs to readjust to the customer's request or face the risk of becoming disintermediated.

EXHIBIT 4: U.S. Farming Working Capital

Source: USDA-ERS, U.S. farm sector financial indicators, 2016–2023F, Data as of Feb. 7, 2023.

Emerging Risk #2: Lower Farmer Working Capital

Working capital – calculated simply by subtracting current liabilities from current assets – is an important indication of operating liquidity and/or capital available for business reinvestment. For the U.S. farming sector overall, working capital (in current 2023 dollars) increased steadily from 2016 to the 2022 peak as one would expect with rising grain prices and farmer income *(Exhibit 4).*

The problem, however, is that working capital during the 2021/2022 cycle peak total averaged $138 billion, down from $215 billion during the 2012 peak (all figures in current 2023 dollars.) What this means is that the industry's liquidity position in this post-cycle peak is considerably weaker this time around vs. last time, despite much higher agriculture commodity prices. Not only do ag retailers have less cash, the ratio of working capital to gross revenues is down too, another indicator of stress on the sector.

Although strategic purchases of new farm equipment and facilities (across crop, dairy, and livestock farming) during a period of historically low interest rates during 2021 and 2022 may justify current lower working capital, the reality is that farmers and ranchers will have less available cash to purchase inputs during the next downturn, unless they increase debt. And with higher interest rates, rising labor and other costs, ag retailers could see a trading down towards cheaper inputs during the next downturn, which in turn will pressure ag retailer revenues.

To be clear, financial stress at the farm level has not yet become apparent and in fact, farm and agricultural production loan delinquencies have actually trended down over the past three years and remain at decade low levels.[4] We would expect incremental signs of stress to begin emerging later in 2023 or in early 2024.

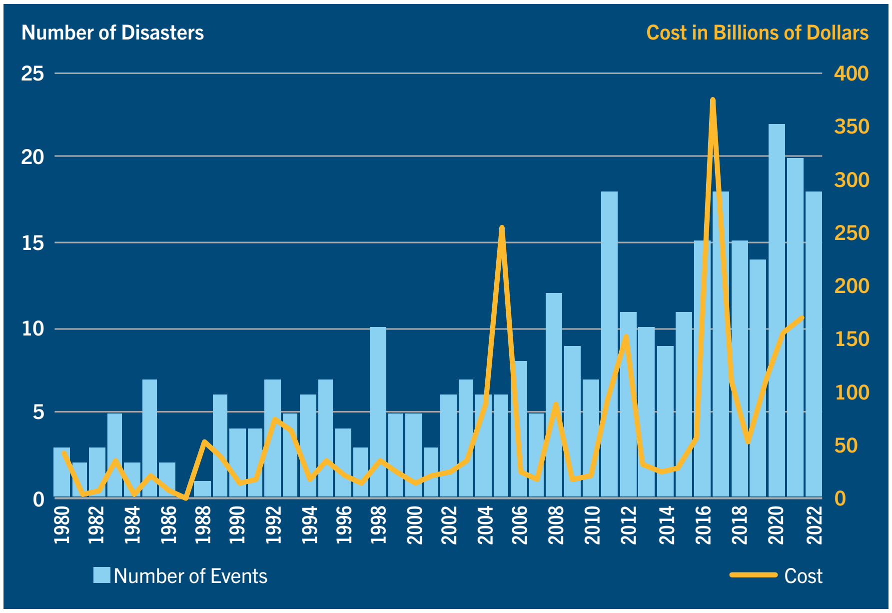
Emerging Risk #3: Higher Insurance Costs

Agricultural cooperatives across the United States are facing an environment of increasing property insurance costs and in some cases, limited availability of coverage. In short, catastrophic natural disasters are leading to higher property insurance costs. The cost of property-casualty premiums has risen sharply for the 2023 renewal season (between 25% and 75%), following a period of above average property losses due to natural catastrophes. Losses from extreme weather totaled nearly $170 billion in 2022 vs. $155 billion in 2021, well above the long-term average *(Exhibit 5).*

Implications for Cooperatives

Looking at the first two risks – changing farmer needs and preferences and farmers' lower current levels of working capital – we see a sobering reality for farm supply cooperatives, but one that has a straight-forward solution. Farm customers will increasingly scrutinize the types of inputs they purchase, creating retailer opportunities in the short and long run:

EXHIBIT 5: United States Billion-Dollar Disasters By Year (CPI-Adjusted)



Source: NOAA National Centers for Environmental Information (NCEI) U.S. Billion-Dollar Weather and Climate Disasters (2023). Disasters include drought, wildfire, floods, winter storms, freezes, severe storms and tropical cyclones.

The withdrawal of a regional Nebraska-based carrier and a pullback in risk by a major national carrier (Nationwide Insurance) has spiked insurance costs and in some cases, created a lack of available commercial insurance coverage. Farm supply cooperatives will need to explore alternative risk transfer mechanisms including, but not limited to self-insuring through the creation of a captive insurer, merging with another cooperative in a different region to achieve greater businesses diversification (which is appealing to the commercial insurer) and/or creating some form of contingent capital facility with a strategic partner outside of the traditional ag retailing industry.

- In the short run, the opportunity for ag retailers is to broaden their product offerings beyond traditional NPK (nitrogen, phosphorous, potash) fertilizers and branded herbicides, pesticides and fungicides to include more affordable specialty plant nutrients and biological pest management products.
- In the long-run, the opportunity for ag retailers is to provide greater tangible value to customers by integrating agronomic products and advice with precision agriculture solutions (whether predictive or descriptive) and value-added customer application services.

The third risk – higher property-casualty insurance costs – may require co-ops to get creative.

Conclusions

The outlook for agricultural retailers is generally favorable for 2023 following a year of record profits in 2022. However, the sector faces an emerging set of risks that could depress profit margins and challenge traditional business models in the years ahead. Lower levels of industry working capital, higher property insurance costs, and changing grower needs are three of the key emerging issues that ag retailers will need to navigate over the next five years. A downturn in the crop cycle – after several years of consecutive high profits – is likely during 2024 or shortly thereafter. The prospect of lower grain prices and financial pressure at the farm level, combined with the newly emerging risks, has business implications that ag retailers should begin preparing for now.

References

[1] *"Nebraska drought expected to ease over the next few months," Lincoln Journal Star, Matt Olberding, March 16, 2023. https://journalstar.com/news/local/nebraska-drought-expected-to-ease-over-the-next-few-months/article_e21f072e-c40b-11ed-b183-db23b2e9067a.html*

[2] *CropLife 100 Ranking, CropLife Magazine, December 2022.*

[3] *"The Ag Retailer of the Future," Farm Journal Update webinar, Jan 19, 2023. https://www.youtube.com/watch?v=mJ6DQ-5QSzI&feature=youtu.be*

[4] *S&P Capital IQ, CIQ Pro: Data Dispatch: Agricultural loan delinquency rates fall further below 1%, lowest in decade-plus (spglobal.com)*

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