Agriculture Retailers in the Midwest: Opportunities and Challenges

February 2013

This whitepaper is focused primarily on agriculture retailers, defined to include grain elevators and cooperatives, fertilizer, chemical and seed retailers, as well as feed mills. All of these retailers are focused on providing products and services in support of production agriculture operations.
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Executive Summary

Sikich conducted a survey of agriculture retailers in Indiana and Illinois soliciting responses to a variety of questions regarding their businesses as well as future business plans. The survey was conducted from November 2012 to January 2013.

In the short term, agriculture retailers appear cautious after having less grain in storage and expectations of lower sales of products and services in 2013. The survey also revealed specific business risks related to customer consolidation and increased regulation, among other risks.

Long term, these risks and other factors will result in some retailers diversifying, while others will consider consolidation by acquisition, or being acquired.

Impact of Lower Yields from 2012 Harvest

Agriculture is an industry where investment dollars are flowing, and research and development related to new biotechnology as well as equipment is robust. Expectations of higher yields by 2030 are being discussed by economists and agronomists alike. Jim Schultz of Open Prairie Ventures, a Midwest-based venture capital firm, predicts that innovative technology, like that being developed by the major biotechnology firms in the U.S., will account for 70 percent of increase in yields by 2030. Key drivers of the growth in interest of this industry include world demand for food due to population growth and improvement in the standard of living across the globe, increasing the demand for more protein. Corn-based ethanol is also a current driver of higher demand. Overall, agriculture continues to have a very positive long-term outlook.

Agriculture retailers are also making significant investments, as expectations of higher yields create the need for more storage capacity to handle more bushels of grain. Specifically, 77 percent of our survey respondents (Figure 1) made significant investments in their plant and equipment in the last three years. These investments were focused on improving efficiencies and in turn, increasing the amount of product processed and stored. Upgrades to equipment at grain elevators included increasing drying capacity and improvements in legs and pits to increase dumping speed.

Figure 1: Products and Services Offered By Survey Respondents
However, lower yields in 2012 are expected to temper additional investment. Only 31 percent of the survey respondents expect to expand their capacity for storing grain, fertilizer, chemicals, or other inputs in the next 12 months. Of the survey respondents, 20 percent reported that they were using less than half of their licensed storage after the harvest. An additional 40 percent are using less than 75 percent of their licensed storage capacity. The United States Department of Agriculture (USDA) estimates that by the end of this summer, U.S. corn stockpiles will reach a 17-year low. There is no price incentive to carry over the 2012 crop, so in turn, there will be plenty of empty storage for the 2013 crop. A typical retailer that offers warehousing and storage to farmers has significant capital invested in their storage facilities, and their ability to generate income is largely dependent on maximizing the use of those assets.

In terms of retailers selling fertilizer and chemicals, 83 percent of the respondents believe that the demand for these products will be the same or lower for the 2013 crop year. There is much debate as to whether the lower yields allowed some of the nutrients to stay in the fields, allowing farmers to apply less in fertilizer and chemicals. Others believe that demand for grain and the good financial health of farmers indicate that farmers will invest more in fertilizer and chemicals to maximize yields for a world hungry for their products, and with prices at record highs.

Another cause for concern was the impact of Aflatoxin. The hot, dry summer experienced throughout the Midwest increased the occurrence of this toxin. In fact, 78 percent of our survey respondents were either moderately concerned or very concerned with the impact of Aflatoxin or other diseases. At the National Grain and Feed Association (NGFA) Country Elevator Conference in Omaha, Nebraska in December 2012, concerns were raised about the effectiveness and consistency of testing methods applied by country elevators, and whether they would detect Aflatoxin at rates that could cause the product to be rejected by foreign and domestic users. It stands to reason that given the expectation for lower origination, retailers that warehouse grain may have relaxed their standards for receipt of grain and testing for Aflatoxin. The testing standard for acceptance of corn is Aflatoxin levels of fewer than 20 parts per billion.

Given these risks, retailers that unknowingly have Aflatoxin-contaminated grain beyond acceptable levels may in fact accept market discounts, or worse, have grain rejected by their customers. In addition, retailers will have to monitor 2012 crop delivered in the spring from farmers who stored grain on the farm to reduce service costs and discounts. In the event this corn has higher levels of Aflatoxin, this could be problematic for retailers when they deliver the grain to exporters or processors. There are limited alternative uses for rejected corn, which will generally force the retailer to accept a discount on the value. In addition, they still have a contract to fill with a customer who wants Number 2 Yellow Corn.

A small percentage of retailers that responded to our survey experienced losses from customers that either had inadequate crop insurance or could not deliver on their contracts for grain.

As we can see, Mother Nature can quickly change the health of agribusiness and immediate plans of investment in plant and equipment.
Consolidation or Expansion?
Consolidation is a common theme in all industries today. Retirement expectations of Baby Boomers/Founders, access to capital to maintain or expand operations, and the burden of regulation are at the top of the list for reasons we see consolidation. Agriculture retailers appear to be on the same path.

Nearly 50 percent of the survey respondents indicated that they expected either to acquire another business, or be acquired, within the next five years. Because of this, we expect fewer larger retailers to exist in the next five years. In a related question asking only the opinion of respondents, 57 percent believe that there will be significant consolidation in the next five years. Retailers are feeling pressure from their customers to continue investing to improve the level of service. Retailers that maintain and store grain need to gain efficiencies during that short harvest period in the fall (such as being able to receive 40,000 bushels of grain or more per hour at each location). Farmers can no longer afford to wait in lines to dump grain and are demanding faster processes. Fertilizer and chemical applicators are increasing in size, capacity and price in order to efficiently meet the needs of larger farmers.

And the competition is no longer just another retailer—on-farm storage capacity continues to grow. Farmers are purchasing equipment to apply inputs so that they have more control. In order to remain competitive, these investments may be necessary. Large capital investments are risky and require the burden of debt or use of existing working capital. Some retail operations will not be willing or able to take these risks.

Additionally, retailers in drought-ravished areas who store grain may see the need to sell their operation rather than experience losses until the next crop is harvested.

An alternative strategy would be to expand the operation to include other products or services. Retailers who simply offer grain storage and handling may expand into offering inputs such as fertilizer, chemical and seed inputs, as an example. Forty-one percent of survey respondents indicated that they expect to expand their products or services in the next two to five years.

These responses indicate that changes are coming for retailers. The agriculture industry is starting to act more and more like other industries, where more capital is available for expansion and innovation, and consolidation is occurring. Management and boards are faced with strategic decisions on how to respond to these conditions, but clearly, change is on the horizon.

![Figure 2: Planned Capital Investments in Plant and Equipment](image-url)
Fewer, Larger Customers
In 1910, there were more than six million family farms in the U.S. By 2000 that number had declined to approximately two million farms. The number of acres farmed has declined at a much slower pace. Thus, the average farm size measured in acres is on the rise, and the advent of mega-farmers is upon us.

Other factors impacting farming operations are that fewer individuals in the next generation are choosing farming as a full-time profession. The average age of today’s farmer is estimated at 55 and many of them will leave the farm to children who will simply manage the farm as an investment, not as an operator. The USDA estimates that by 2027, 70 percent of the farms in the U.S. will change hands.

In many counties across Illinois and Indiana, an increasing number of farms are being operated by non-owner tenant farmers. Dale Aupperle, president of Heartland Ag in Decatur, Illinois, says his research indicates that 55 percent of U.S. farmland is owned by people whose chief occupation is not farming. In Macon County, Illinois, over 70 percent of farms are owned by investors who have a lease arrangement with a farmer. These tenant farmers are getting control of more and more land as this generational turnover occurs. As this happens, agriculture retailers are seeing their customer base shrink in numbers, but not necessarily in volume. This can create concentration risk, in which a business is dependent on fewer, larger customers. Eighty-five percent of survey respondents indicated that they are experiencing this (Figure 3).

Similarly, 86 percent of respondents indicated that they saw farmer consolidation as a significant threat to their business. Large corporate farmers like Tom Farms in Indiana look at their 17,000-acre farming operation much like a manufacturing operation, implementing standardized processes and lean manufacturing to maximize returns. Other large farmers are considering vertical integration where they store their own grain or develop direct relationships with suppliers of inputs, bypassing the retailer. Input costs can be reduced by buying direct from the manufacturer in the case of feed, fertilizer or chemicals. Storage and other handling fees charged by elevators also become more noticeable when the number of bushels increases.
Along with the concentration risk, larger farmers expect higher credit lines for inputs, better terms, more competitive service fees, and lower discounts for foreign materials and moisture. There are a number of other challenges related to credit risk. Farmers have traditionally been unsophisticated with their financial reporting, and retailers may soon require them to provide better reporting to ensure they have other sources of repayment in the event the crop fails. Farmers will resist these requests for better information which will likely involve more professional fees. These are difficult issues for retailers to address. Maintaining the volume from these larger farmers is important, but being fair to the entire customer base while protecting the credit of the operation is critical.

To encourage customer retention, we would expect that retailers such as country elevators will soon develop customer loyalty or discount programs based on the amount of products or services consumed. These types of programs already exist in many other industries and it seems only natural that this will be a retention strategy. Loss of significant bushels of origination due to the departure of one or more large customers can be devastating to a remote elevator, so boards and management will be challenged to deploy retention strategies, while being fair to all of their customers.

Retailers that sell inputs will face similar challenges, although manufacturers of those products already offer discounts and rebates based on volumes purchased by customers.

**Additional Business Issues Facing Ag Retailers**

Business in general faces a long list of regulatory burdens. Environmental groups are critical of much of the technology developed by companies designed to resist insects and weeds, while maximizing the yields of row crops. Cash-strapped federal, state and local governments are searching for taxes and fees to fill budget shortfalls. Worker safety is an increasing concern for those operating large equipment, entering grain bins and handling chemicals. The U.S. Food and Drug Administration’s (FDA) updated rules on food safety standards are coming in 2013.

The results of our survey illustrate specific business issues facing retailers in Figure 4. An increase in regulation makes it harder for smaller operations to institute policies and procedures and to invest the appropriate amount of resources into maintaining compliance. These factors will lead to decisions by some to simply consolidate their operation into a larger, better-capitalized agribusiness.

*Figure 4: Future Business Issues for Agriculture Retailers*
Competition from larger agriculture consolidators was also considered a significant business issue by 20 percent of the respondents. Large competitors have the strategic advantage of more capital, better discounts from suppliers, and more pricing power with their customers. Historically, they have had more influence over government policy and the ability to obtain government support for expansion in return for job growth.

**Conclusions**

It is increasingly difficult to compete as a small business in many industry sectors. It would seem this is true for agriculture retailers as well. They experienced changes in their business performance in 2012 due to adverse weather conditions. Further, until all of the grain is shipped from the 2012 crop, we will not know the final impact of Alfatoxin on retailers and whether it will have a significant impact on the value of inventory and financial performance. All of these factors weigh especially heavily on smaller retailers. It reminds all businesses that sufficient equity and careful use of debt is important to sustain leaner years, such as the one some retailers will experience due to a smaller 2012 crop to sell into the market, and quite possibly, lower demand for chemicals and fertilizer.

Larger customers and competitors both create significant challenges for agriculture retailers. In some cases, the larger customer could become a competitor. Concentration is probably inevitable for most retailers—farmers are getting bigger everywhere. Therefore, creative customer retention strategies are necessary to ensure that concentration risk is mitigated.

Lastly, agriculture retailers need to give more attention to regulatory bodies, such as the Occupational Safety and Health Administration, Environmental Protection Agency, U.S. Department of Labor, Internal Revenue Service, and FDA at the federal level. At the state and local level, new taxes and fees will be proposed. More involvement in trade associations and maintaining awareness of these proposals will help retailers understand the impact of new and proposed rules. More resources need to be dedicated to these issues—for awareness as well as for compliance.

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**About Sikich**

Sikich LLP, a leading accounting, advisory, investment banking, technology and managed services firm, has more than 400 employees throughout the country. Founded in 1982, Sikich now ranks as one of the country’s Top 50 Certified Public Accounting firms and is among the top 1% of all enterprise resource planning solution partners in the world. From corporations and non-profits to state and local governments, Sikich clients can use a broad spectrum of services and products that help them reach long-term, strategic goals. Visit www.sikich.com to discover how you can elevate performance in your organization.

Sikich has a team of professionals dedicated to the agriculture industry. Contact Tom Bayer, partner-in-charge of the agriculture vertical at tbayer@sikich.com or 217.862.1704.