On the Nature of Direct Sales: Risks and Rewards

The mission we embarked on to diversify the Prairie grain-economy is largely driven by the risks we foresee in our producers' dependence on (or captivity to) bulk-trades. There is a sense of comfort that comes to producers with recent achievements, continued yield-increases and export-growth. Generally producers have done well, but many among them face a debt-overhang that is not going to go away unless their margins increase, undermining their ability to invest and advance into the future.

Even more worrisome is the "future" of producer-margins from bulk-trades, which we fear are going to be further squeezed as a result of prevailing trends in global-markets. We tend not to pay much attention to these developments but crop-yields are on the rise in emerging regions, particularly across Caucasia and Central-Asia. These developments are not accidental; behind the agricultural revival of this vast region is China, with its *Road-and-Belt Initiatives* and farm-level support programs.

China became our largest grain destination, taking a fifth of our grain-exports, but now these trades are threatened with considerable uncertainty on the horizon. Even if our trade-relations could be repaired, China is turning to its west for grain-imports, cheaper sources of most of what they need, sources we would be hard-pressed to compete with. It is imperative that producers diversify away from grains exported in bulk, to specialty-crops sold direct and exported in containers with higher margins.

Our mission is to promote direct-sales, and to that end we have a two-pronged agenda to enable containerized-exports -- trade-facilitation and logistics-services. We are confident in the viability of our mission, which will facilitate higher-value and higher-margin exports, but we are not advocating that producers abandon bulk-channels altogether; it will take time for our "vision" to materialize, and there are risks associated with direct-sales that have to be carefully mitigated or managed.

Bulk trades have considerable appeal to producers; they can continue to grow what they are accustomed to and generally get paid at farm-gate with no trade risks. But we cannot be blind to global market pressures that may squeeze producer-margins further, even to a point where it is no longer viable to grow staple-crops in our high-cost region. The path we are advocating is not just driven by greed but may become a necessity; however, specialization and selling direct may come with certain risks.

One extreme example is growing an exotic crop, in the hope of finding buyers that would pay a premium for, but being left holding the bag with no buyers in sight. A more common risk is buyers reneging on contracts, and skipping payment after the order is shipped and even delivered. These latter trade-risks can be avoided or at least mitigated by insisting on advance payments or secure letters-of-credit, or conventional export-insurance remedies to spread trade-risks across multiple trades.

Virtues and drawbacks of bulk-trades

Before the containerized-era bulk-systems were the only means of exporting grains overseas. CWB had developed effective marketing and shipping channels to sell all the board-grains producers grew for export, while also providing price guarantees to ensure producer well-being at times of poor harvests or slumps in global markets. With CWB's dissolution and privatization of its assets, it was hoped that producers would do even better with multiple grain companies competing to buy their crops.

It is debatable whether market liberalization efforts achieved the desired industry conditions for producers to get a fair share of export-proceeds, but we have little interest in dwelling on these matters. Export volumes increased and producers did fairly well; our main concern now is the system's future prospects. We fear that our bulk-exports are going to come under increasing pressure from emerging grain-growing regions that compete from a much a lower cost-base than our Prairies.

We have to make an effort to wean our dependency on bulk-exports by specializing in higher-value crops, which tend to sell in smaller quantities and are not conducive to bulk-handling. We have the capacity to grow crops with highly specific attributes that could fetch higher prices in export markets, but they have to be sold to end-users through direct channels and delivered in containers to preserve their identity. This transition cannot happen overnight and comes with certain risks to producers.

A grain-economy reliant on bulk-systems brings considerable comfort and security to producers. The grain companies, custodians of bulk-systems and the trades they serve, are the main purchasers. This gives producers some choice in what they grow without having to worry about crop attributes, at least not as much as in selling direct to end-users with specific requirements. Most importantly, grain companies buy under contract and pay reliably, protecting producers from any trade-risks.

It is tempting to stick to the *status quo* to avoid the risks that may come with further specialization, what we are calling for. But to guard themselves against declining staple-export prices and volumes, producers must start thinking about reaching to new markets. As bulk-exports come under competitive pressure, producers will bear the brunt of the margin-squeeze, not the grain-companies with more market-power.

Risks associated with direct sales

The alternative path we provide through direct-channels has much greater revenue and margin prospects for producers. However, they bring certain production-burdens and trade-risks that producers have to be cognizant of and manage to protect their interests. There can be little doubt about the potential rewards that could come from this *paradigm-shift*, but it is not as easy as growing the staples grain-companies are willing to buy and assume the risks beyond farm-gates.

At the production end, scientific and technological means are there to grow a much greater variety of specialty grades or types of crops, but there are many factors beyond producers' control, weather conditions being first and foremost. Also, the word "specialty" implies certain attributes that buyers look for but are not as easy to achieve in the fields as on factory-floors or construction-sites. Precision-farming has advanced greatly but is not quite what we can call a grow-to-specification process.

The specialization quest we are advocating requires careful crop-choices on the part of producers, based on an understanding of their own soil, weather and growth conditions, but equally important are *market-risks*. In order to avoid these risks producers have to develop a much deeper understanding of end-market conditions, not just crop prices but consumption and production trends, as well as industry and supply-chain structures that can go a long way to target reputable corporate buyers.

There are also *trade-risks* to consider. Due diligence into prospective buyers can go a long way to minimize trade-risks, but still, sales contracts have to be structured to mitigate these risks by requiring up-front commitment-fees as well as progress payments in the course of the production process, akin to interim payments in the execution of construction or contract-manufacturing projects. Most importantly, cash payments or transfers, or at least LOCs from credible sources, must be required.

There are more risks involved in direct-sales than what producers are accustomed to in bulk-trades, which we will never underestimate in our trade-facilitation efforts. But as long as these risks are recognized and mitigated, they are worth taking as the rewards of specialization far outweigh them, particularly in view of the future risks that bulk-grain prices face -- hardly talked about in grain-industry circles but are real.

Favoured channels: contract sales

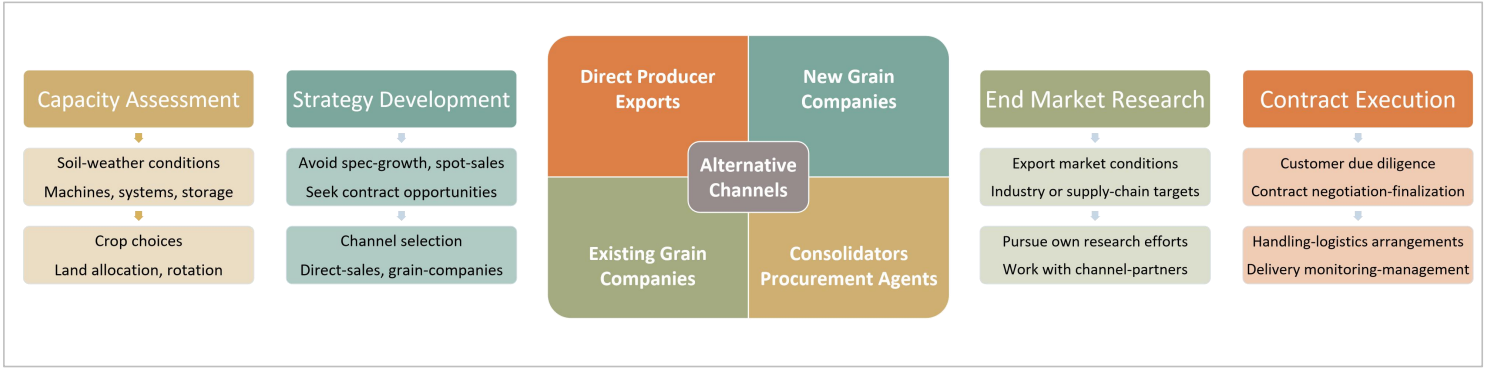
Even in today's highly bulk-oriented trade environment, producers make crop-choices based on price expectations, like how much land to allocate to wheat versus canola. However, outside the bounds of staple-crops that go into bulk-trades, or established markets like pulses, we recommend against speculative-growth. In diversifying to specialty crops, producers ought to follow a well charted course, guided by market-research, with evidence of buyer interest in direct purchases.

There is also a tendency to view direct-exports as today's *spot-sales*, keeping stock in farm-bins to sell opportunistically into domestic or US markets. This may prove profitable in small quantities for producers with an inclination to hustle-and-bustle, but cannot be the basis for a viable diversification strategy away from bulk-trades. Producers ought to be looking for reliable direct-sales channels that can sustain steady volumes to justify the effort and investment they put into specialization.

In our opinion, based on past experience in export markets, *contract-sales* constitute the most effective and safe building blocks of sustainable direct-export strategies. Thus, we intend to pursue our market research efforts to identify credible corporate buyers with specialty-crop needs (including special-grades of our export-staples) that are willing to commit to sizeable purchase-contracts. These volumes may be too large to supply from any one farm, but can still be fulfilled from multiple sources.

Naturally we will not have a monopoly on these kinds of export initiatives. All we hope to do is to have a demonstration-effect, attracting others to follow on our foot-steps. Like we saw in pulse-markets, new grain companies will emerge, specializing in containerized exports of specialty grains, specific grades of staples exported in bulk or new crop varieties. Also, today's grain companies, now focused on bulk-trades, are likely to turn their attention to containerized exports of specialty-crops.

Thus, our mission is aimed at transforming today's grain-economy, largely captive to bulk-trades to a much more dynamic, market-driven one, with higher-value crops in the offering, exporting through competitive channels, and leaving higher-margins from export-proceeds to producers. This transformation, however, will not happen overnight; it will take many crop-years for producers to adjust to the new order.



Managing crop-portfolio risks

Our specialization-drive will add more value to the grain-economy, and leave higher-margins to producers, but will bring higher risks than producers face in bulk-trades. As we note repeatedly, crop-specialization and shift to direct-sales channels involve risk-reward trade-offs, compelling producers to make wise crop-choices and take trade-risks seriously. Producers should approach the process cautiously, weighing the risks as seriously as the prospects, and following a carefully charted course.

Diversification is not new to Prairie producers; they switched from board-grains to canola, but this shift was still within bulk-trades, with no added trade-risks. The shift to pulses came with a higher value proposition, but as new processing and export channels emerged, producers were shielded from trade-risks. Many producers with large enough land-holdings adopted crop-rotation patterns (typically wheat, canola and pulses in the mix) but without exposing themselves to undue market risks.

The strategy we are advocating involves a broader range of crop varieties and grades through direct-sales and containerized-shipment channels, posing higher risks -- be it production, market or trade related. To guard against these risks, we strongly recommend staying away from speculative production initiatives, reliance on spot-sales, and allocating huge chunks of one's land to any one crop-type. Also, it would be prudent to choose crops with back-up sales potential in North American markets.

The safest diversification path to specialty crops is through contract-channels -- finding reputable corporate buyers in end-markets who are prepared to pay a premium for crop quality and attributes. Contractual arrangements guard against trade-risks, with secure progress payments that not only help producers but also tie the buyers down with advance cash-outlays. Also, we would advised producers to form clubs or alliances to share contract loads, thereby spread trade-risks.

We highly recommend producers to take new initiatives, but wisely and prudently, keeping in mind that specialization involves risk-reward trade-offs. This is akin to portfolio-risk-management; as you would not bet all your wealth in any one stock or asset, don't bet your entire farm on any one export-contract, no matter how secure or rewarding it may look. Develop a strategy but take small steps along the way.