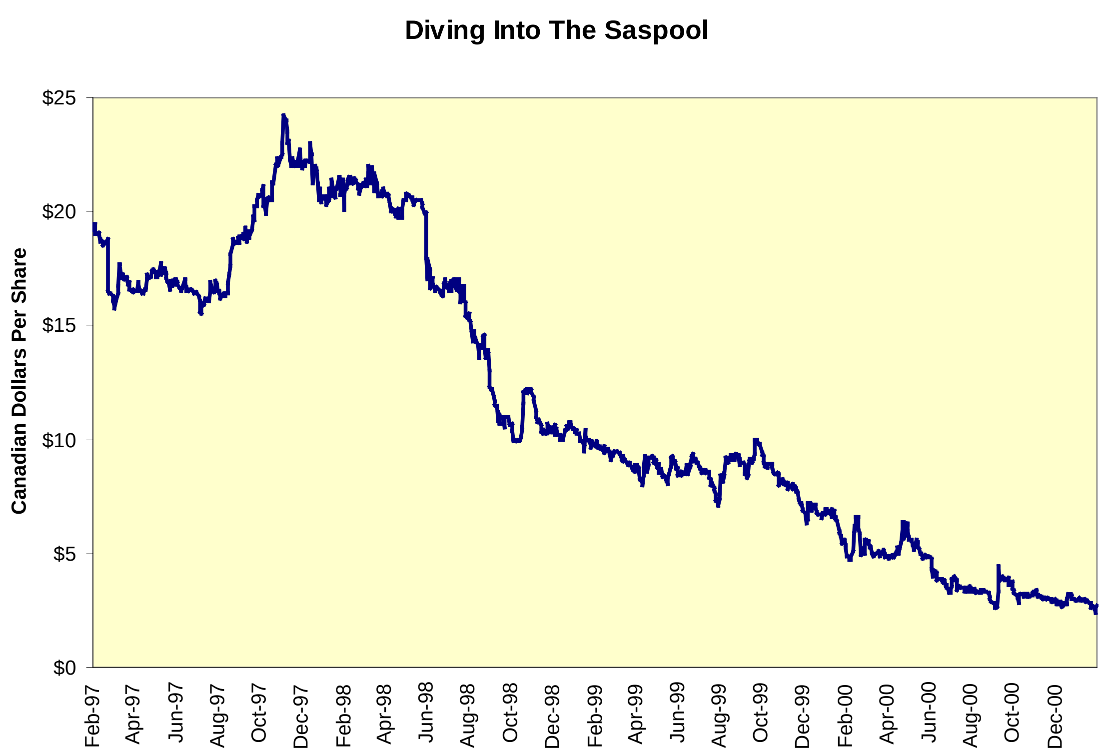
Old Economy Business, New Economy Results

Labels are great. They allow us to speak in a shorthand that conveys the veneer of expertise while remaining comfortably clueless. One example is the division of the business world into Old and New Economy camps, with all of the connotations pertaining thereto.

We know, of course, that anything redolent of New Economy has had a tough year since the NASDAQ bubble burst last March. In addition, we know there's been a stealth bull market underway in many of the previously ignored value stocks and in the basic materials industries that comprise the Old Economy.

Are there firms in basic industries with time-proven business models that have provided us with New Economy-style equity vaporization? Yes; let's take the example of the Saskatchewan Wheat Pool, Canada's largest publicly traded agribusiness cooperative with more than 70,000 members. Saspool, as it's known to cognoscenti, is in the business of buying wheat, barley, canola (an oilseed), and other crops from farmers and then marketing them worldwide. That's been done before, right? So, how come Saspool's total return over the past year has been a negative 49.5%, and that comes on top of several years of bad performance beginning with the 1997 Asian financial crisis.

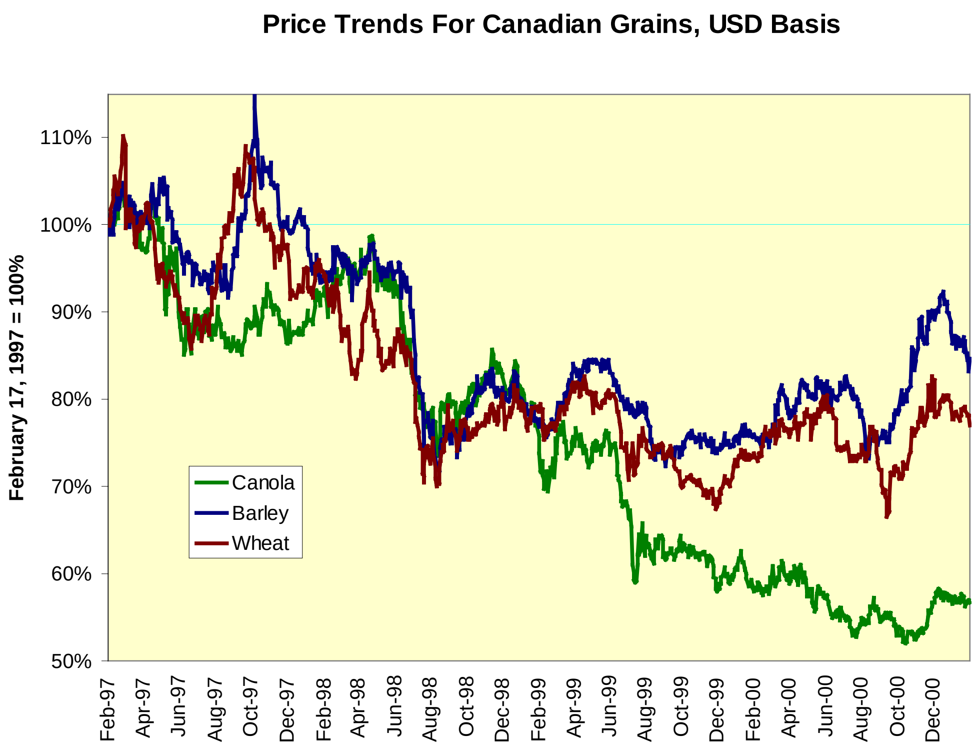


Part of the answer lies in the Asian and Russian crises; as food budgets in the region were cut, less meat and hence less livestock feed were demanded. That may have been a satisfactory explanation for the large drop in 1998, but what accounts for the continued erosion since?

Normally, it is commodity producers who get the short end of the stick in both rising and falling markets. Since it is difficult to add value to an undifferentiated commodity like wheat, it is the various merchandisers and processors, the despised middlemen, who capture the economic rent of higher prices. The producer, the venerated yeoman farmer, gets stuck with lower prices. This permanent inability of commodity producers, farmers especially, to prosper goes a very long way toward explaining why the percentage of the population living on farms has been declining for centuries.

A Squeezed Middleman

Saspool, in a stroke of ineptitude, has gotten squeezed during a period of nearly-continuously declining farm prices in Canada. Even worse, the firm should have enjoyed a competitive pricing advantage in global export markets as the Canadian dollar (CAD) fell against the U.S. dollar, but they failed to take advantage of this gift.

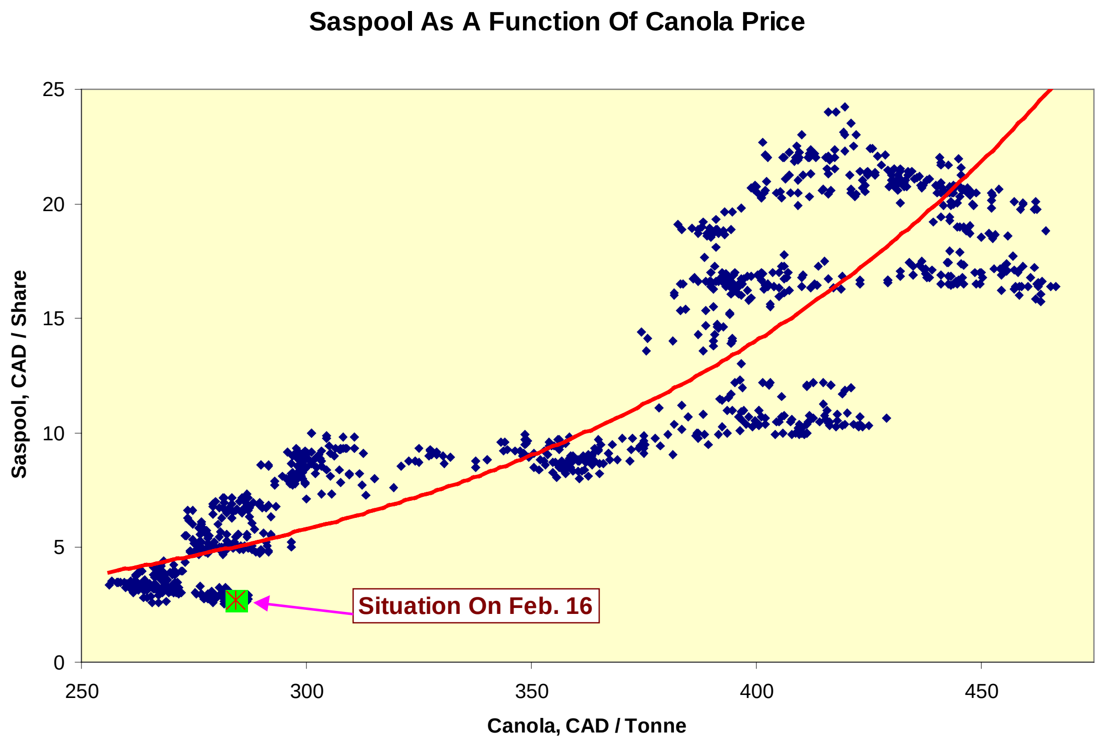


This performance reflects the political pressure on Saspool. Unlike state-directed marketing boards, which have a clean track record of underpaying farmers, Saspool is a cooperative beholden more to the interests of its producer members than to its investors. Hence while Dominion Bond Rating Service downgraded Saspool's debt to 'BB (low)' with negative implications on February 15th, and while the money-losing Saspool is struggling to renegotiate C$ 750 million in debt with a consortium of banks, Saspool is urging Canadian consumers to "show support for farmers on Food Freedom Day," whatever that means. Moreover, senior management, instead of worrying about the increased competition from its Manitoba rival Agricore or from U.S.-based Conagra and Louis Dreyfus, is spending time urging the government to provide even more in assistance to farmers hit by higher energy prices.

This is so Canada. The country at times looks like a laboratory experiment showing us what would have happened if George McGovern won the 1972 election. Saspool, rather than urging its members to increase efficiency and expose themselves to global market forces, is crying for further production subsidies so farmers can continue on their merry ways. Is it any wonder the price of canola continues to fall in such an environment?

A Trading Opportunity
Companies and commodities in distress create trading opportunities, and the present combination of low canola prices and weak Saspool shares is no exception. The relationship between the two is the classic exponential curve we've seen before:

$$\text{Saspool} = .409 * \exp(.0088 * \text{canola}),\ r\text{-squared} = .816$$



The logic behind this relationship is compelling. In a rising canola price market, Saspool can lag in payments to farmers while selling the oilseed later in world markets at higher prices. Margins expand, and the company's fortunes grow exponentially. In a low price environment, the relationship is reversed, and farmers get paid the earlier high price while global customers pay the later low price.

The trade suggested here is a purchase of Saspool shares hedged with put options on canola. Saspool trades on the Toronto Stock Exchange and canola trades on the Winnipeg Commodity Exchange. Put options on canola are suggested as global oilseed prices already reflect a record soybean crop in South America, and while these prices are unlikely to fall significantly further, they could explode higher should the North American summer turn hot and dry.

This trade combination provides a rare opportunity to buy both a stock and a commodity at low prices. Buy low, sell high. That's the idea, isn't it?