

Given the ongoing stress being experienced by much of the dairy industry, the credit staff of Western AgCredit met on January 20, 2011 to review the condition of the industry, to discuss financing options, and to receive guidance relative to lending to this important segment of the agricultural industry. Following is a summary of the information regarding the condition of the dairy industry.

## **Overview of Industry Conditions and Forecasts**

### **Review of the dairy economy and contributing factors over the past 3 years**

- **Milk Prices** - The Class III price for 2010 averaged \$14.41, which is a significant improvement over the \$11.36 average for 2009. Current futures prices for 2011 reflect further strengthening of Class III prices to \$15.68; beginning with prices below \$14 and improving to over \$16 by mid-year. This would indicate that most producers would average over \$15.00 in 2010 and close to \$16.50 for 2011. (Futures price increases in February, after the meeting, have brought the number for 2011 up to \$17.80.)
- **Feed Costs** - Although 2011 milk prices are projected to increase by 9% over 2010, based on current futures prices (or 23% using the updated futures), the prices for dairy feed have already increased significantly more.
  - The current price for corn is 50% higher than January 2010 and 35% higher than the average for 2010.
  - The current price for soy is 19% higher than January 2010 and 17% higher than the average for 2010.
  - The current price for dairy quality hay is 40% higher than prices during the 2010 harvest, and it is difficult to find.
- Dairies that already have sufficient hay to carry them to first crop in 2011, and who have locked in prices for their other feed needs, have the potential to generate positive margins during the first half of 2011 with the forecast strengthening of milk prices. However, dairies that need to purchase significant amounts of feed will likely have negative margins even with the higher milk prices due to the increasing feed costs.
- **Milk/Feed Price Ratio** - The Milk/Feed Price Ratio for 2010 averaged 2.27. (A ratio below 2.50 historically has resulted in industry contraction and reduced production due to lack of profitability and increasing financial stress.) The ratio of 2.27 for 2010 was significantly better than the historic low of 1.77 in 2009. However, it is not a level that would support a significant recovery of equity in the industry.
- Each of the last three years (2008 – 2010) the ratio has been below historic averages and the 2.50 level. Other than 2009, the milk prices during the period have been favorable compared to history, but the price of feed has continued to cause a problem with margins.
- Despite the adverse economic conditions indicated by the low Milk/Feed Price Ratio, milk production continues to expand. The economic forces and borrowing limits that have historically caused a reduction in production during periods when margins are stressed are not yet generating the expected results.

- **Regulatory Issues** – The dairy industry is also experiencing challenges from regulations related to Food Safety, Environmental Activism and Immigration.
- EPA Issues/Concerns with regards to dairy facilities may be an exit strategy in itself if the operation cannot justify the cost of increasing manure management requirements. This has affected some dairies in our territory, not only with costly improvements but with high monetary penalties.
- Proposed EPA limits on spreading manure on frozen, snow packed farm land could increase waste management costs.
- FDA Food Safety proposals could negatively impact the sale of cull cows as well as result in increased testing of milk at the dairy. Compliance with some proposals for documenting use of medications could be very difficult.
- Strict enforcement of Immigration laws could impact the workforce at dairies that rely on outside labor.

## **Collateral and Asset Value Issues**

- **Cattle Values**
  - Mature Cow values declined by approximately \$200/head (15-20%) during 2010.
  - Replacement heifer values declined by \$200-300/head (approximately 25%)
  - High beef cattle prices are helping to keep prices for cull cows high, which improves the returns for ongoing operations as well as the overall results from a herd liquidation.
  - Three recent herd dispersal sales indicate some strengthening of prices. Average quality Jersey cattle continue to have a price premium relative to average quality Holstein cattle.
- **Real Estate Values** – There have not been any dairy facility sales in Utah or Idaho in the past two years. There are a few dairies listed for sale in Utah, but all have very high asking prices and the sellers are not actively reducing the prices to attract purchasers. Despite the weakness in the dairy industry, new facility construction has continued, but at a slower pace than a few years ago. The Appraisal Department has documentation of 34 dairy sales nationally in the past year.
  - The larger, more expensive dairy facilities have shown the highest level of “external depreciation” due to industry challenges. (This is primarily dairy facilities that were somewhat “overbuilt”. Buyers are less willing to pay for the “extras”.)
  - Older, small dairy facilities are likely to be less desirable to the typical buyer. However, they may be attractive to a local producers looking for

an inexpensive, temporary option for expanding or for hospital barns or freshening cow facilities.

**Commitment to the Dairy Industry** – Despite the challenges over the past few years, the Association is very committed to the dairy industry. It is important to remember that many dairies remain financially sound and have good prospect for the future when margins come back to “normal”.