

Status of the Dairy Industry – Spring 2010

Western AgCredit management and loan officers who service loans to dairy producers met in April 2010 to discuss the dairy industry. The following is a summary of some of the information that was discussed. The review of the recent trends in the Milk/Feed Price Ratio helps to quantify why the dairy industry has felt so much stress over the past 18 – 24 months.

Review of Milk/Feed Price Ratio

The Milk-Feed Price Ratio is the value of one pound of milk divided by the cost of one pound of a basic feed ration. Therefore, the Milk-Feed Price Ratio is a simple proxy for profitability.

A higher Ratio indicates a larger margin between milk and feed prices. So the lower the Ratio, the less income is available to pay debt and other expenses after paying for feed. As a general rule, the Ratio has been higher during periods of better milk prices and lower during periods of weak milk prices.

When milk prices were less volatile, Milk-Feed Price Ratios consistently below 2.5 have historically triggered herd liquidation and ratios above 3.5 have triggered herd expansion. However, the materiality of the impact of changes in the ratio is influenced by differences in the price of milk between the periods compared. A low Milk-Feed Price Ratio does not have as severe of an impact on overall profitability during periods of very high milk prices as it does during periods of average to low milk prices.

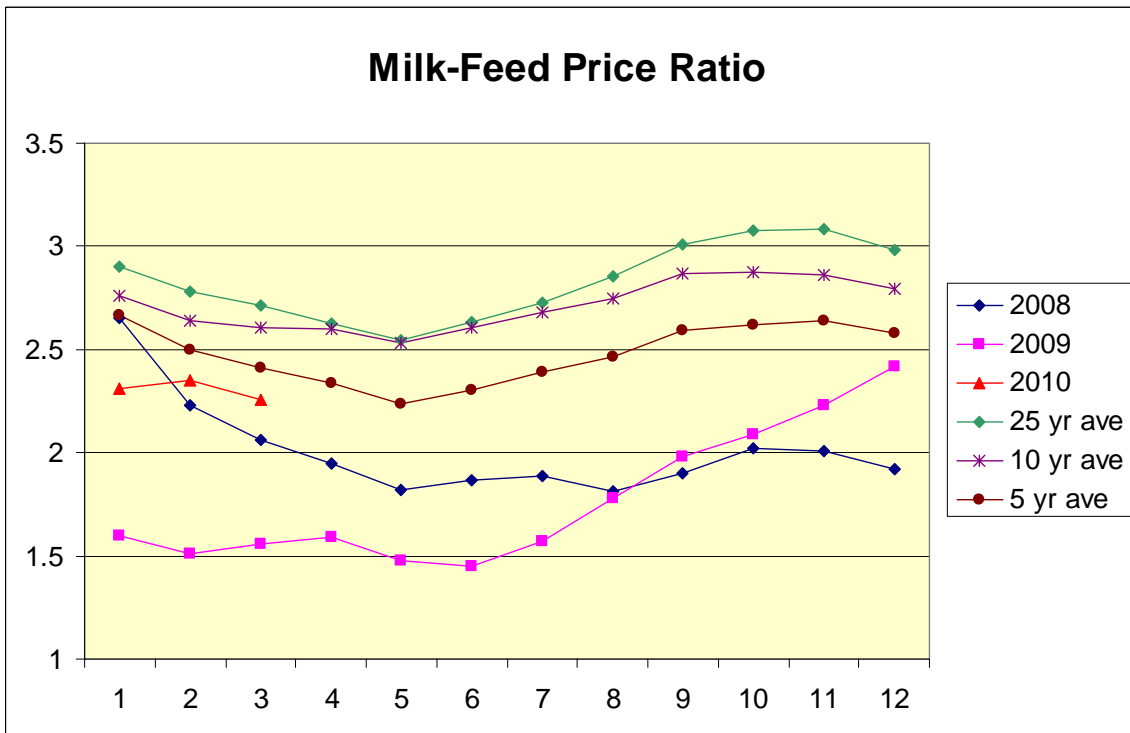
For example, 2007 Class III prices averaged \$18.04, which were a historic high for the year. With a Milk-Feed Price Ratio of 2.81, an operation receiving Class III prices with the average feed costs would have \$11.61 remaining for other expenses and debt service. Even though the Ratio was much closer to the 2.5 herd liquidation level than the 3.5 herd expansion level, the \$11.61 of funds available after feed costs was the highest ever and herd expansion was triggered.

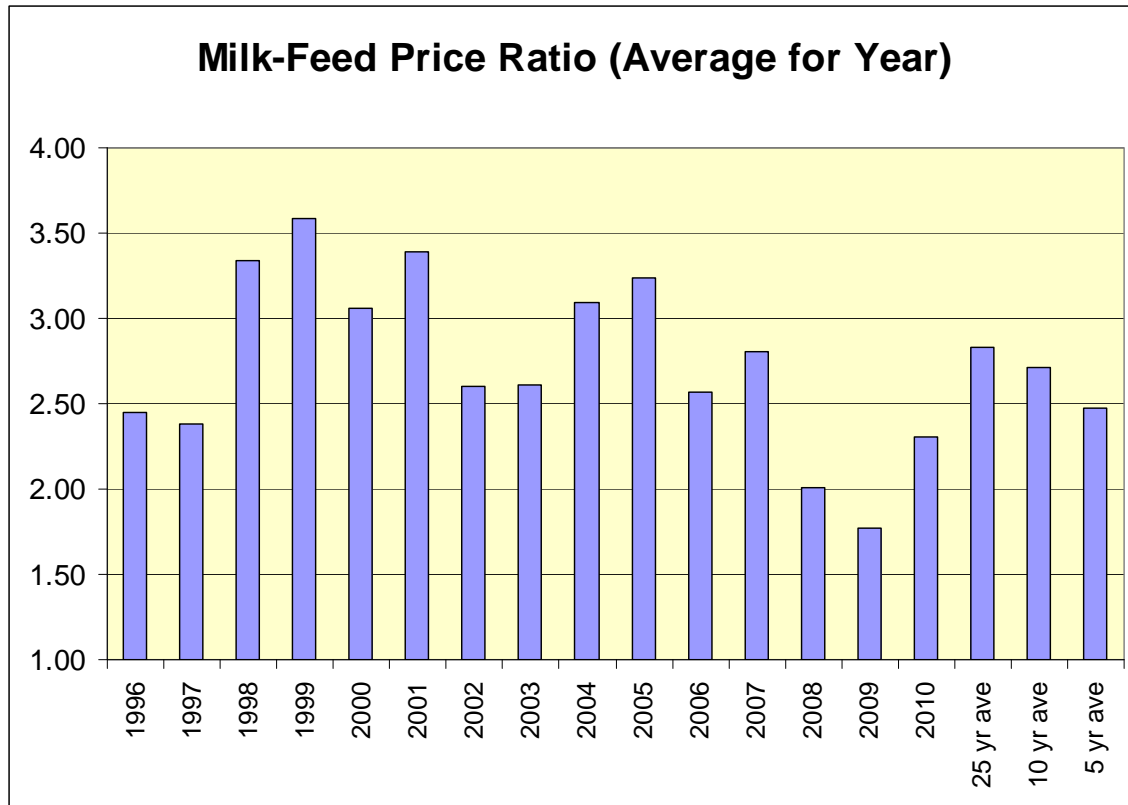
In 2008, higher feed costs drove the Ratio down to 2.01 despite Class III milk prices being maintained at an average of \$17.44 for the year. The combination of a historically low Ratio and a milk price near historic highs largely offset each other. The funds available after feed costs for the year were \$8.77, which is above the 10 year average of \$8.20. So the impact of the very low Ratio did not have the degree of financial impact that would normally be expected by a Ratio far below 2.5. (Because other non-feed costs also increased in 2008, the benefit of the \$8.77 margin did not result in operating profits to all producers at the level that would have been realized with normal costs.)

In 2009, feed costs moderated somewhat, but milk prices dropped more materially. Therefore, the Ratio averaged only 1.77 and Class III milk prices fell to an average of only \$11.36. This resulted in a margin over the cost of feed of only \$4.97. So although

the ratio only declined 12%, the funds available for debt service and other expenses dropped by 45%.

- ◆ **Overview of the Impact of the past 2 years** *Please also see the graphs below*
 - Prior to 2009, 2008 had the lowest average Milk-Feed Price Ratio in the past 25 years at 2.01.
 - By comparison, the average Ratio for 2003 and 2006 (the last two low milk price cycles) were 2.61 and 2.57 respectively.
 - The Ratio for 2009 averaged 1.77. Therefore, the two lowest years in the past 25 years occurred back to back in 2008 and 2009.
 - The Ratio has been below 2.5 since February 2008. It dropped below 2.0 in April 2008 for the first time in 25 years, and remained below 2.0 for 16 of the next 18 months.





Industry Outlook

- 2010 milk prices will be better than 2009 milk prices
 - Although cash prices and futures markets are off somewhat from levels at the end of 2009, they are consistently higher than 2009 levels. (Currently 2010 prices are running about \$3/cwt higher than 2009.)
 - Futures prices are still very volatile and seem to be seeking a consistent direction – so they cannot be relied upon with total confidence
- Based on current price estimates:
 - 2010 will not be a “big recovery” year
 - Individual producers will not be able to significantly reduce 2009 carryover loan balances with prices at these levels
 - However, most producers should not see continuing material equity losses. (Other than the spring months with expected yearly lows for milk prices, 2010 is not expected to be a year with further “bleeding” of equity)
- There are signs of increasing domestic and world demand for dairy products. But it will take time to rebuild demand to prior levels.
- Heifer numbers remain high and have the potential to negatively impact chances for a quick, significant increase in prices.
- Beef prices are at levels that are supportive of increased culling of dairy cows either to generate cash or to improve the herd
- There is little evidence to support any quick, significant change in supply

- Although producer groups are exploring and encouraging Supply Management, there is not a general consensus on what program could be implemented. So any change will take time.
 - There are signs and reports that other lenders' dairy portfolios are experiencing significant stress and that the lenders may be changing their approaches which could reduce production. However, we cannot predict how the other lenders will respond or what impact their responses will have on reducing supply.
- Historically, material downturns in prices are followed by a period with prices far above average. This type of price recovery will again be necessary for producers to recover the losses of the past two years. However, there is no information to be able to predict how soon prices will bounce back to those "above average" levels again.
- There seems to be potential for lower feed costs in the next 2 years, as compared to the prior 2 years, unless there is a material reduction in the production of forage and grains.
 - The Milk-Feed Price Ratio for the first 3 months of 2010 has improved to 2.31, but it is still below historic averages
 - If milk prices and feed prices stay in line with current futures prices, many operators will have a chance to make some financial progress
 - Likely not much gain in working capital, as cash flows including full debt service remain tight
 - Overall gain in net worth as term debts are reduced through normal amortizations

Conclusions

- The dairy industry in Utah will survive. There are producers with efficiencies and equities sufficient to weather the adversity.
- The primary objective for 2010 is to maintain equity – avoid additional losses – and to have producers reasonably reduce debt as opportunities exist.

Strategies available to Producers

- Look for any further opportunities to reduce unnecessary expenses or to defer capital expenditures.
- Pay close attention to production levels and milk components to be able to maximize income; to the extent it does not cause additional costs to exceed the amount of the additional income
- There is an opportunity to cull older or lower producing cows with current higher prices for cull cows
- When there are periods of higher milk prices, take the opportunity to reduce debt and keep budgets lean.
- Explore opportunities for improving risk management in the areas of milk pricing and input costs.