The Dairy Business World in 2013

Gary Sipiorski
Dairy Development Manager
Vita Plus Corporation
Email: gsipiorski@vitaplus.com

THE ELECTIONS ARE BEHIND US

The 2012 elections are behind us with most political leaders now in their positions for at least the next 2 yr. Polarization appears to be alive and well. Be aware of what is going on. Regardless of which way the political winds are blowing, make sure you make the right decisions for your barnyard.

THE 2008 / 2012 FARM BILL

As expected, the 2008 Farm Bill was just pushed onto the desks of the 113th Congress for at least 9 more months with no new Farm Bill yet. At this point nothing will change on the surface other than authorized spending having 2 classifications as ***Mandated*** (that which is funded) and ***Discretionary*** (that which is acknowledged with no funding). People are still digging through the paperwork to see what is what. Once again do what is right for you.

TODAY'S BUSINESS WORLD-VOLATILITY, UNCERTAINTY, AND OPPORTUNITY

Gone are the days before 1983 when dairy producers could rely on a milk support of $13.50 / cwt of milk. The milk support number was nearly 80 % of what was called ***parity*** or near the cost of producing milk with a margin. As a general rule dairy producers spent half of their milk check to cover operating expenses and the other half could be left in the checkbook and used for such things as capital purchases. After the 1980s the price support was lowered and milk became more volatile. Milk price fluctuations ramped up in the 1990s with huge changes running wild after the turn of the century. This unpredictable bounce creates a budgeting nightmare for dairy producers and worse yet for the businesses that serve the industry and rely on regular payments.

Oddly enough there are 3 words now that hover over the dairy industry today. They run the field of business failure and success. They are ***volatility***, which highlights the movements in milk prices; ***uncertainty***, which represents factors beyond a dairy producer's reach half way around the world; and ***opportunity***, which is filling the demands of an ever growing world population. Let's deal separately with each word and cite examples of how they affect your customer's ability to pay you.

Volatility

Of the 199 B lb of milk produced in the U.S. 13.5 % is exported. Milk powders and whey powders top the list with 53 % of the export share. Cheese and butter make up the balance of the product leaving our shores. The impact on the milk check from these exports amounts to $2.00 to $3.00 added to the value of a hundredweight of milk for which a dairy producer is paid.

A 26 ¢ movement in whey powder alone adds $1.50 to the Class III price. The challenge now for the U.S. dairy producer is to continue to compete with other milk producing countries around the world. Milk processors are now taking aggressive steps to ask importers what their desired standards are for the products they want. In the past most U.S. product was manufactured according to USDA government standard. If processors could not sell product overseas they could always rely on Uncle Sam to buy the surplus. The problem was it was not the product of choice for other countries. Therefore the U.S. product was only used when no one else could supply a product. In other words the U.S. was *last in* and *first out* of the world market. This caused volatility as other countries such as New Zealand and Australia, which are highly reliant on rain fall for their pasture system, took the market when rains were plentiful. New Zealand ships out 95 % of their milk in the form of powder to their closest customers in the Pacific Rim. That does not leave much of a market left for the U.S. powder market.

Simple things, such as the color of cheese and butter specified by the USDA for purchases, turn away worldwide buyers as well. European tariffs also keep U.S. products on the price bubble. Allegations were aimed at the U.S. dairy and meat industry by the European Union (**EU**) regarding drug residues. The U.S. Federal Drug Administration (**FDA**) answered the comments with a year-long commitment to blind sample milk from 900 herds that had past violations of milk or meat residues and 900 herds that had no historical violations. Sometime in the early part of 2013 the FDA will release the findings of the 1,800 double blind milk samplings. The European export market lies in the crosshairs of the testing results and if any action will be taken.

A recent trade dispute between the U.S. and Mexico over banning Mexican semi-trucks from entering the U.S. was met with a 25 % tariff on U.S. cheese imported into Mexico. Mexico is one of our largest importers of dairy products. Here is an example of a U.S. Teamsters labor union dispute indirectly lowering the U.S. dairy producer's pay price due to decreased cheese sales. The dispute has now been settled and U.S. dairy products are again moving across the Mexican border.

Feed costs have also added to the volatility for dairy producers. In 2012, 40 % of the U.S. 11 B bushel corn crop went to ethanol production, while 38 % of the corn crop was fed to livestock. Hats off to the corn growers who 10 yr ago wanted a large customer to compete for the $2.00 / bushel corn. They have found that customer in the gas tank. The unintended consequences were high feed costs for all livestock producers. Even though this did not affect the milk check directly, it did affect the bottom line for dairy producers who buy corn. Dairy nutritionists have been filling some of the diet with by-product feeds as a partial substitution for corn. Expectations in 2013 are for a 14.74 B bushel corn crop with a 165 bushel yield. The weather will determine the results.

All of these examples add to volatile swings in milk demand and price. In most cases these issues are out of the control of dairy producers, yet these factors have an impact on the income and expense budgeting of dairy producers.

Uncertainty

The second ingredient in today's economy is the uncertainty of what to expect based on the decisions or circumstances of others. A prime example of this is the debt crisis in Europe. Countries like Greece, Italy, Spain, Ireland, and others must implement tough austerity policies. When pensions are cut and taxes are raised people have less disposable incomes and they become unruly. The 27 member EU, the International Monetary Fund, and European Central Banks are all trying to devise a solution and enough money to add to and restructure sovereign debt. Some of these countries may not be a large importer of U.S. dairy products, but their financial stability affects the trade of other products from the U.S. That in turn affects domestic jobs, and that has an impact on domestic buying decisions. Dairy products are at the top of the food chain in protein quality along with meats. If people do not have a job, the dinner decisions change from steak to pizza to noodles.

Uncertainty boils over into the importance of other trading partners such as Central America, India, Korea, China, and other Pacific Rim countries. Many of these countries are important trading partners. Some have fragile economies. China's needs are great. Their economy appears to be continuing just below double digit growth, but economic bubble talk continues. Their decisions are made by a small number of people and their next economic moves are never certain. The melamine and aflatoxin problems of the Chinese milk supply have convinced most consumers to read the country of origin on the label before purchasing. Now that U.S. processors are asking importers what protein and fat levels they want in their powder, the whole Pacific Rim has opened up for sales. With 13.5 % of the dairy products exported there is no turning back.

The two mandates of the Federal Reserve are to keep inflation in check, which has been defined as in the 2 % annual range, and keep the unemployment rate low, no more than 6.5 %. The main tool the Fed has is to set a target rate for the Over Night Fed Funds Rate (**FF**), which banks use to borrow short-term money or over-night money back and forth. Some of the Fed major policies in the last 4 yr have been to buy long-term mortgages, buy U.S. Treasury Bonds; and print money. In August of 2011 the Fed openly said they would leave the FF rate at 0.25 % until June 2013. This takes some of the guess work out the Fed's thinking. On January 25, 2012 the Federal Open Market Committee voted for interest rates to remain at the present low levels until the end of 2014. The December 2012 comments by the Federal Reserve which were released in early January 2013, stated that they will be monitoring the overall economy closely. Some members of the committee are voicing their interest in discontinuing the buying of U.S. Treasury Bonds, therefore starting to allow interest rates to move higher.

After the subprime housing melt down and disintegration of commercial real estate loans, banking regulators have clamped down with new lending rules. Legislators like Barney Frank and Chris Dodd encouraged borrowing and home ownership fueled by the lack of mortgage making rules of Fannie Mae and Freddie Mac. Home ownership is good, but with home mortgages of 125 % of home values and no down payments in many cases, the housing bubble broke. After the 2008 financial crisis the Frank/Dobb financial regulation legislation was passed. There are now 6,000 pages of new banking legislation. Lenders may be flush with funds, but they have regulators with fresh rules that are limiting lending. Lenders are also sheepish and want to protect their capital with sound loans. Some lenders have gone so far as to require 50 % equity positions and 3 yr of historically sound cash flows. They also want a financial projection with good logic and firm pro forma expectations.

The land frenzy continues with cornbelt land purchases upwards of $20,000 / ac. Some of the driving forces are:

1) Grain producers with a lot of cash on hand
2) High corn and soybean prices
3) Land right next to your land that you have waited 20 yr to buy and now it came available
4) Dairy producers with a need for land for nutrient management plans
5) Low interest rates

The banking and Farm Credit regulators are now getting very nervous about a land bubble. Potential land buyers need to be aware that many lenders are now requiring a 50 % or more cash down payment. This way if land prices go south there still should be equity left on the balance sheet. Land purchases need to be approached with caution. Stress test new borrowing with 15 % cuts in commodity prices, 8 % interest rates, and 15 % asset value declines. Make sure you are not betting the farm on the outcome. In other words make sure you can cash flow a land purchase through times of financial stress.

Uncertainty continues with an extension of rather than a new Farm Bill. A dairy margin protection program and stabilization mechanism was proposed in the unpassed Farm Bill. The International Dairy Food Association outwardly opposed dairy stabilization. They wanted a continuing abundant supply of milk for domestic use and to export world-wide. The Congressional Super Committee failed to cut $1.2 trillion from the U.S. budget and Congress was faced with mandatory cuts, which were enacted March 1. Automatic farm budget cuts are part of those mandates. All of the sequestered $1.2 trillion cuts are now being implemented.

It should be noted that the proposed $155 B USDA budget has 80 % of the funding ear marked for supplemental nutrition assistance programs (**SNAP**), otherwise known as food stamps.

Opportunity

In light of what has already been written there is a great opportunity for agriculture. The world population has now moved passed the 7 B mark. By 2050 it is expected that there will be 9.1 B mouths to feed. The U.S. has to realize that 95 % of the world's population lives outside of our borders. In 1964 there were 0.75 ac / person of tillable land in the world, today there is 0.22 ac / person. Some calculations even show fewer acres per person. The only way 30 % more people can be satisfied in the future is through an increase in productivity.

The business of feeding people will

not be handed to U.S. agriculture. It will have to be earned through a competitive process. The subsidies in Europe are to come to an end by 2015. Tariffs are to be eliminated as well. Many European producers will find themselves in a very different economy, one in which U.S. farmers have been sharpening their skills for years.

The opportunities are within reach of all dairy producers. Many of the little details can bring big rewards. Making sure forage is harvested at the right time, inoculated, and preserved; in addition limiting waste saves the dairy producer in nutrients that do not have to be purchased. Keeping all animals comfortable adds to daily gains and increases in milk production. Keeping livestock mortality and morbidity low pays big dividends. Controlling the somatic cell count and maximizing the milk components by using today's technology in additives and other designed feeding programs adds cents per hundredweights that add dollars to the milk check.

There are new consumer dairy grocery products available and being developed that add to end-product user satisfaction. Greek yogurt is increasing in popularity. Dairy promotion organizations have partnered with national pizza chains like Domino's and Pizza Hut to promote new products. McDonald's has added more cheese and dairy into their menu with smoothie yogurt drinks and coffees with milk and cream added.

Volatility and uncertainty exist, but there is plenty of room for opportunity for those looking for it and those that are in a position to capture it. Even though there is a drag on the world and U.S. economies, interest rates have been lowered by the Central Banks to encourage borrowing, building, expansion, and job growth. These historically low interest rates present a great time to lock in long-term money. The borrower must have a reasonable equity position of at least 40 % post-expansion for most lenders. The borrower must also be able to show past positive cash flows and realistic projections. If money is to be borrowed it should be to purchase productive assets that will generate a reasonable annual return and increase over all efficiencies. An example for an expanding dairy herd would be for every $1.00 borrowed there should be at least 70 ¢/yr generated in gross income.

SUMMARY

In summary, among the volatility and uncertainty there is plenty of opportunity. Margins will remain tight in all of agriculture. It is more important today than ever to know key financials and understand what drives them. Understand and keep current balance sheets. Study the last 3 yr of cash flows and know what drove them. Do realistic projections with good logic for the top 5 major expenses. Consider margin protection programs on income and expense items. Watch the details on your operations and give plenty of thought to the big decisions. Keep abreast of macro-economic conditions domestically and worldwide that may affect your business. Always focus on the micro-economics of what is best for the individual farming operation and what is in their checkbook.