Today's Business World: Volatility, Uncertainty, and Opportunity

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Gone are the days before 1983 when dairy producers could rely on a milk support of $13.50/cwt. 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 80's, the price support was lowered and milk became more volatile. Milk price fluctuations ramped up in the 90's with huge changes running wild after the turn of the century. This unpredictable bounce creates a budgeting nightmare for dairy producers, and worst 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 to fill the demands of an ever growing world population. Let's deal separately with each word and sight examples of how they affect your customer's ability to pay you.

Volatility

Thirteen percent of the 198 billion pounds of milk produced in the U.S. 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 milkcheck from these exports amounts to $2.00 to 4.00/cwt added to what a dairy producer is paid. A $0.26 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 made according to USDA government standards. 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 first choice of a product other countries wanted. 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 causes volatility as other countries, such as New Zealand and Australia which are highly reliant on rain fall for their pasture system, to take the market when rains are plentiful. New Zealand must ship 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, will turn away world wide buyers as well. European tariffs also keep U.S. products on the price bubble. During the Christmas season of 2011, a butter shortage occurred in Norway due to increased

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baking usage and a poor anticipation of demand. Dire calls were made to the Professional Dairy Producers of Wisconsin and the Wisconsin Milk Marketing Board by frantic bakers trying to obtain butter. While black market butter was smuggled into the country at $25.00/lb.

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 that indirectly lowered 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 boards.

Feed costs also have added to the volatility for dairy producers. In the U.S., 40% of the 12.3 billion bushel corn crop goes to ethanol production. About 38% of the corn crop is feed to livestock. Hats off to the corn growers who 10 years ago wanted a large customer to compete for the $2.00/ bu. corn price. They have found that customer in the gas tank. The unintended consequences are high feed costs for all livestock producers. Even though this does not affect the milk check directly, it does affect the bottom line for dairy producers who must buy corn. Dairy nutritionists have been filling some of the diet with byproduct and substituting corn.

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 members of the European Union, International Monetary Fund, and European Central Banks are all trying to come up with 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 go 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 a near 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% of the dairy products exported, there is no turning back.

The two mandates of the Federal Reserve are to keep inflation in check and keep the unemployment rate low. The main tool the Fed has is to set a target rate for the Over Night Fed Funds Rate **(FF)** with which banks use to borrow short term money overnight, money back and forth. Some of the Feds major policies in the last 4 years 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. Recent comments by the Federal Reserve Chairman, Ben Bernanke, stated that they will be closely monitoring the overall economy and make changes when necessary, always keeping an eye on jobs and inflation. However, other future decisions are keeping the market on edge and create additional uncertainty.

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 nearly 300 new banking rules within 2,300 pages of legislation. All lenders may be flush with funds, but they have regulators with fresh rules that are limiting lending. Lenders also are sheepish and want to protect their capital with sound loans. Some lenders have gone so far as to require 50% equity positions and three years of historical sound cash flows. They also want a financial projection with good logic and firm proforma expectations.

Everyone knew it was coming, and it happened in December 2011. Seventy-four acres of farm land in Iowa was purchased for $20,250 an acre. 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 years to buy and now it came available, 4) dairy producers with a need of land for nutrient management plans, and 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 25% cuts in commodity prices, 8% interest rates, and 25% declinesi n assets value. Make sure you are not betting the farm on the come. In other words, make sure you can cash flow a land purchase through times of financial stress.

Uncertainty is also present in the 2012 Farm Bill. A dairy margin protection program and stabilization mechanism was to be inserted into the Farm Bill. The failure of the Congressional Super Committee to cut one and one half trillion dollars from the budget and implement other programs, such as the dairy portion of Farm Bill, has gone away. Now, the Farm Bill will go back to the drawing boards. The International Dairy Food Association outwardly opposed dairy stabilization. They want a continuing abundant supply of milk for domestic use and to export worldwide.

It should be noted that the proposed $155 billion dollar USDA budget has 80% of the funding ear marked for nutrition programs, or otherwise known as food stamps.

The fate of the Farm Bill is unknown at this time with huge general budget cuts needed and no one wanting to give up any ground. All grain and livestock programs reside in the land of uncertainty at this time. The ongoing elections and the chasm of political polarization will not help the entire budget or Farm Bill process.

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 billion mark. By 2050, it is expected that there will be 9.1 billion mouths to feed. The U.S. has to realize that 95% of the world's population lives outside of our boarders. In 1964, there were 0.75 acres of tillable land per person in the world; today there is 0.22 acres per person. Some calculations even show fewer acres per person. The only way 30% more people can be satisfied in the future is an increase in productivity.

The business of feeding people will not be handed to U.S. agriculture. It will have to be earned and competed for. 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 which U.S. farmers have been sharpening their skills on for years.

The opportunities are at the reach of all dairy producers. Many of the little details can bring big rewards. Making sure forage is harvested at the right time, inoculated, preserved, and waste is limited will save the dairy producer in nutrients that do not have to be purchased. Keeping all animals comfortable will add to daily gains and increases in milk production. Keeping livestock mortality and morbidity low will pay 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 hundred weights that will 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.

Conclusions

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 in 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. An example of an expanding dairy herd would be for every $1.00 borrowed, there should be at least $0.75 generated every year in gross income.

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 the key financials and understand what drives them. Understand and keep current balance sheets. Study the last 3 years of cash flows and know what drove them. Do realistic projections with good logic in the top 5 major expenses. Consider margin protection programs on income and expense items. Watch the details on your operations and give good 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 your farming operation and what is in your checkbook.