The Milkweed

Dairy's best information and insights

Issue No. 450 • January 2017

"Float like a butterfly, sting like a bee."
— Muhammad Ali

U.S. Positioned as Only Global Source for Residual Butter & Cream

by Pete Hardin

Presently, and probably for at least the next six to nine months, the United States looks like the only source of discretionary cream and butter among major dairy nations in the world. We've seen these trends evolving during the second half of 2016. Domestic demand is strong for butter and high-fat content dairy products, such as whole milk, cheese and sour cream.

During the second half of 2016, U.S. butter inventories have been whittled down dramatically. But the U.S. butter situation is only part of a larger global pattern. Butter is quite scarce in Europe and Oceania. Europe is in the midst of a program to pay dairy farmers to reduce milk output. That subsidy started in October 2016 and will continue at least through March 2017. EU butter prices have climbed nearly $1.00/lb. since early June 2016, according to USDA's Dairy Market News.

Meanwhile "down under," milk production is lagging dramatically in both New Zealand and Australia. Weather and economic events are pulling down farm milk flow in those countries. Butter is so scarce in Australia that Dairy Market News recently reported that small-scale food firms using butter in their product mixes had been reduced to buying butter off the shelves at their local supermarkets.

And now Canada's dairy and food processors are coming to the United States for large quantities of cream supplies. Reports indicate that during October and November 2016, five to six million liters of cream were exported from the United States to Canada each month. Sources tell *The Milkweed* that Canada is caught in an increasingly tight cream supply/demand squeeze. That source related that virtually all cream in Canada is being produced into "prints" (i.e. table-grade butter). Residual cream users, such as baking and confectionary, are using cream shipped in from the United States. This same source notes that all cream sold to Canada must be "rbGH/rbST-free" and "GMO-free." (Good luck!)

These 11 million liters of cream shipped to Canada during October-November would equal about 6-7 million pounds of butter, by our best "guesstimates." Butter production in the United States fell a about 15 million lbs., compared to the same two-month period.

Those record exports of cream to Canada took place as USDA data noted a sharp drop-off in this nation's butter production and shrinking inventories of butter in U.S. warehouses.

In summary: our domestic demand for butter and other high-fat dairy products is growing nicely. And both milk production and butter reserves in Europe and Oceania are low.

Butter marketing and price trends are all positive at the end of 2016. In the analysis of *The Milkweed*, 2017 is poised for an extremely strong demand for butter and cream – a factor that will propel farm milk prices and demand for high-fat dairy cows and heifers.

Tighter butter inventories and scarce global supplies are having a contra-seasonal impact in dairy's cash markets. Normally, about the time that the Thanksgiving turkey is being thawed, domestic butter needs have been filled to meet holiday demand and cash prices for Grade AA start sliding backwards. But not in late 2016. Cash prices for Grade AA butter in trading at the Chicago Mercantile Exchange (CME) generally strengthened as December progressed. Grade AA butter peaked at $2.3475/lb. on December 26 at CME, before edging backwards to hit $2.2775/lb. on Wednesday, January 11.

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Butter Inventory Declines (# & %) October 31-November 30, 2014-2016 (Data in million lbs.)

Year	Oct. 31 Total	Decline (mil. lbs.)	Decline (%)
2014	147.956	34.7	-23.5
2015	78.834	46.2	-25.8
2016	228.157	67.3	-29.5

Source: USDA Monthly Cold Storage Report, November 30, 2016

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The fundamentals of butter and cream demand appear extremely solid at the beginning of 2017. Consumer butter demand is strong. Butter inventories are nose-diving at year's end. Seasonal cream demand for holiday Class II products such as eggnog was strong. Sour cream sales are demonstrating very strong growth during 2016's second half. And consumer purchases of whole milk are growing nicely – moving more milk fat to consumers in beverage form.

During November, USDA's Cold Storage report noted a huge drop in butter inventories. At 160.9 million lbs. on November 30, that means U.S. marketers held 67.3 million lbs. less butter than the October 31, 2016 Cold Storage total – a 29.8% decline. Here are the corresponding numbers for 2014's and 2015's October 31-to-November 30 U.S. butter inventory declines (and percent change): were 34.7 and 46.2 million lbs., respectively.)

From the data presented above, it's clear that during November 2016, a higher percentage of butter moved out of inventories than during the previous two years. Also, the starting inventory figure for October 2016 was significantly higher than the two prior years.

Somewhat curiously, U.S. butter production has fallen off the table during October and November 2016. October's total butter output was 141.6 million lbs. (-4.6% below Oct. 2015). November's

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Swiss Valley Farms' Horrid Finances Plague Prairie Farms Merger

by Pete Hardin

Two medium-sized Midwest dairy cooperatives will put a hastily-announced, proposed merger vote before their members in late January 2017. Financially troubled Swiss Valley Farms (SVF – based in Davenport. Iowa) will be absorbed by Prairie Farms Dairy (Carlinville, Illinois) … if members of both co-ops vote to approve the merger.

The proposed merger was announced in mid-December 2016. Co-op members had about one month to sift through reams of confidential merger details, before they'll vote in the second half of January. SVF members must vote by January 19.

Prairie Farms' primary focus is in fluid milk and cultured products. Prairie Farms counts about 600 dairy producer members, 5,700 employees, 100 distribution facilities, and 35 manufacturing plants. Prairie Farms holdings stretch from Michigan and Ohio over to Iowa and down to Mississippi. In days of old, Prairie Farms was the "gold standard" of dairy co-op profits – often churning profits of close to $2.00/cwt. on all milk processed. Prairie Farms used to pay back about half those earnings as cash about halfway through the following fiscal year, and had a tight, seven-year revolving program for the remainder of those retained earnings. It is believed that Prairie Farms now stretches out the remainder of the retained earnings over a longer time frame.

The past decade (or so) has seen constricted profits at Prairie Farms, due to the difficult competitive environment in fluid processing. In particular, Prairie Farms has earned the competitive wrath of fluid milk giant Dean Foods. But the past year or two have seen improved profits at Prairie Farms, industry sources report.

If members of both cooperatives vote their approval, the deal would be completed by mid-2017. One flustered SVF producer puzzled why the co-op had held district membership meetings one week prior to announcing the merger, but co-op leaders made no mention of that pending merger proposal at the early December district meeting.

SVF shed both its fluid milk and cultured products divisions to Prairie Farms in recent years. SVF is now basically engaged in cheese production, processing and marketing at six locations in the Upper Midwest. Those locations include: Luana, Iowa; Faribault, Minnesota; Rochester, Minnesota; Mindoro, Wisconsin; and Shullsburg, Wisconsin (a joint venture with Emmi-Roth Kase.)

Luana, Iowa cheese plant: "White Elephant"

The "White Elephant" in this deal, is the troubled SVF cheese plant at Luana, Iowa. Quality problems have bollixed cheese production at Luana for years. Over the years, large volumes of cheese made at Luana were sold as substandard, at commensurate prices. Former management tried to blame a one-time plant manager for the problem, but the same quality problems persisted after that manager departed. SVF is in the middle of an expensive upgrade at Luana totaling over $40 million. Sources report that about $24 million of that upgrade is for production and warehousing. Another $20 million is dedicated to replacing a whey dryer that dates back to Jimmy Carter's presidency.

SVF counts about 400 member producers. Absent the merger, the $44 million upgrades at Luana would saddle the co-op with ***additional*** (DFA-style) indebtedness equaling about $110,000 per member. So now that debt will be spread among Prairie Farms' members … if the fast-fried merger plan is approved.

SVF has suffered through years of poor management. Legendary-CEO Eugene Quast engineered a spending binge that put SVF in a hole. (Reflective of his excesses, Quast had a thick, white shag carpet installed in his new executive office.) SVF operated with co-managers (Gordie Toyne and Don Bolens) for a period, post-Quast. After Toyne retired, know-nothing Bolens was finally shown the door in early 2016. SVF has heavily drained members' milk checks to compensate for undefined marketing/processing losses. SVF has deducted negative Producer Price Differentials (PPDs) far in excess of prevailing federal milk order PPDs – draining millions of dollars annually from members' milk checks. Current SVF CEO Chris Hoeger is regarded as a decent fellow trying to clean up years of accumulated financial debris.

There have been published reports that Hoeger will stay on post-merger to oversee production of the processing plants that are currently under SVF ownership.

Merger deal promises to repay SVF equities

As proposed, the Prairie Farms/SVF merger proposes to pay outstanding equities held by SVF members. That's a sore subject for many present and former SVF dairy farmers, who have been appalled at recent years' puny dribble back of their moneys held by the co-op. In a couple recent years, SVF members were paid out 10% of their outstanding funds from 2001. A couple years ago, an angry Wisconsin dairy farm woman was threatened with legal action if she didn't quit asking questions about her outstanding SVF equities.

The merger deal proposes to annually pay out 10% of outstanding SVF equities per year, for 10 years, starting in 2018. That means, by 2028, former SVF members will be finally made whole for funds that will have been held *without interest* for as long as 27 years.

SVF has also stalled repayment of members' equity in recent years. Those retained earnings – funds on which members actually incurred income tax liabilities during the years for which the earnings accrued – have dribbled out (at best in recent years). SVF's unaudited Sept. 30, 2016 financials report $47.6 million of "Members' Equity"—interest-free moo-la on which SVF operates.

In early December 2016, SVF held to its custom of distributing UNAUDITED "financial information" for the fiscal year that ended the previous September 30. (Note: Competent directors and management would either have audited financial results within two months and a week or two after the close of a given fiscal year, or else wait until the audits were complete, before holding district meetings for members.)

For whatever an **"unaudited"** financial statement may be worth, the numbers SVF handed out in December 2016 meetings for the fiscal year that closed on Sept. 30, 2016 showed some ugly sores, including:

• An 8% decline in member milk production (at a time when the Upper Midwest saw expanding milk production).

• Accounts payable rose $4.4 million (**+52%!**), but receivables were down by 7.9%. (Note: A 59.9% "spread" between growing accounts payable and receivables is a very, very bad sign.)

• "Pensions/Deferred Liabilities" were $10 million as of Sept. 30, 2016 – an increase of $3.7 million (+58.7%). Those "Pension/Deferred Liabilities" equaled 37% of SVF's average monthly sales for the 9/30/16 fiscal year.

• "Net Sales" for SVF's fiscal year ending Sept. 30, 2016 were $321.9 million – a decline of $51.3 million (-13.7%). Despite that significant decline in "Net Sales," SVF reported operating expenses of $15 million (+44.2%).

From the unaudited 9/30/16 financial information, it's impossible to know how SVF accounts for the huge PPD deductions taken from members' milk checks. In calendar 2015, for example, a disgruntled member calculated for *The Milkweed* that SVF's PPDs from February 2015 through October 2015 had averaged $1.11/cwt. worse than the prevailing federal ordaer PPDs. (That disgruntled producer has since departed SVF.)

From the unaudited Sept. 30, 2016 financial information, it is clear that major portions of the estimated $44 million upgrades at the Luana, Iowa cheese plant have yet to plop on SVF's books – at least on those unaudited numbers released to members in early December. Projects under construction generally do not appear on the books until the project, or at least various stages of the project, are completed.

SVF numbers look bad. SVF is truly the "weak sister" in this proposed merger between dairy cooperatives. The "White Elephant" – the Luana cheese plant – may be just the biggest financial problem facing SVF. In all likelihood, the merger will be approved and Prairie Farms' members will then determine the consistency, texture and aroma of albino elephant dung.

No Audited 9/30/16 SVF Financial Data!

The information packet provided to SVF members (and, we presume, Prairie Farms members) in December contained a glaring weakness: NO AUDITED FINANCIAL NUMBERS FOR THE SVF'S MOST RECENT FISCAL YEAR THAT ENDED SEPTEMBER 30, 2016. Four pages of *unaudited* SVF data were included in the information packet mailed to SVF members. And the complete 9/30/15 financial audit was included, with accompanying footnotes.

Curiously, the 9/30/15 audit contained the "Independent Auditor's Report" dated December 15, 2015 from the accounting firm, Deloitte & Touche LLP. The merger information packets containing the unaudited 9/30/16 SVF finances were mailed out during the second week of December 2016. Thus, a reasonable person might imagine that the management and boards of directors of the two cooperatives could have waited a bit longer, until the latest financial audit was complete, to mail out those information packets. Of course, that notion presumes the independent auditor could make sense of the many, multiple negative measures of SVF's unaudited 9/30/16 financial numbers … even before the indebtedness associated with the improvements of the Luana cheese plant are completed and put on the books.

Failure to provide the latest SVF audit and the accompanying notes from the independent auditor must be viewed as clear proof that the Prairie Farms/SVF merger is fast-fried, "Hurry Up, Shut Up, and Vote Yes" tripe. If Swiss Valley Farms were a milk cow, no rational dairy farmer would want her in the barn.

— Pete Hardin

YOUR CO-OP'S FINANCIAL INFORMATION

September 30, 2016

BALANCE SHEET

September 30

(Dollars in millions)

ASSETS	Unaudited 2016	Actual 2015
Cash	$ 0.1	$ 0.1
Receivables	19.8	21.5
Inventories	33.8	36.2
Other Current Assets	3.0	2.7
Total Current Assets	56.7	60.5
Investments	7.5	6.9
Fixed Assets	51.1	39.6
Other Assets	8.4	7.8
Total Assets	$ 123.7	$ 114.8

LIABILITIES & EQUITY	Unaudited 2016	Actual 2015
Milk & Hauler Payables	$ 11.9	$ 12.2
Accounts Payable	13.0	8.6
Other Liabilities	5.2	4.3
Notes Payable	2.8	1.6
Total Current Liabilities	32.9	26.7
Other Long Term Liabilities	0.1	0.1
Pension/Deferred Liabilities	10.0	6.3
Notes Payable	33.1	34.3
Members' Equity	47.6	47.5
Total Liabilities & Equity	$ 123.7	$ 114.8

Cooperative Milk Volume (in pounds)

(includes non-members)

2016 1,163,631,953

2015 1,264,942,404

These unaudited financial details were distributed at Swiss Valley Farms' district meetings in December 2016.

SWISS VALLEY FARMS MILK PREMIUMS

paid out to co-op members during the past fiscal year.

Money received over the federal order price for the year ended September 30, 2016

(Dollars in millions)

	2016	2015
Quality	$ 3.3	$ 3.8
Volume	3.4	3.6
Hauling	1.7	1.7
Affidavit Premium	3.6	3.7
Over Order Premium	(6.9)	(8.1)
Total Premiums	$ 5.1	$ 4.7
Per cwt. avg for Grade A:	$0.52	$0.43

STATEMENT OF OPERATIONS

For the year ended September 30

(Dollars in millions)

	Unaudited 2016	Actual 2015	% of Change
Net Sales	$ 321.9	$ 373.2	(13.7)
Cost of Sales	306.2	363.4	(15.7)
Gross Margin	15.7	9.8	60.2
Gross Margin %	4.9	2.6	
Operating Expenses	15.0	10.4	44.2
Interest Expense	1.4	1.5	(6.7)
Other Income (Expense), Net	2.4	2.4	
Net Income/(Loss) Before Taxes	1.7	0.3	466.7
Tax Expense (Benefit)	0.4	(0.9)	
Net Income/(Loss) After Taxes	$ 1.3	$ 1.2	8.3

What You Own as a SVF Co-op Member

Faribault, Minn.
Blue Cheese, Gorgonzola
Aging of Gouda & Cheddar

Rochester & Spring Valley, Minn.
Club Cheese, Pasteurized Process Cheese, Enzyme-modified Cheese

Luana, Iowa
Swiss & Baby Swiss Block, Gouda Block, Cream Cheese/Neufchatel & Whey

Mindoro, Wis.
Blue Cheese, Gorgonzola

Shullsburg, Wis. (JV with Emmi–Roth Käse)
Baby Swiss, other Swiss varieties