

The Milkweed

Dairy's best marketing info and insight

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Moody's to DFA: Take Money from Members' Milk Checks

by Pete Hardin

Already under the glare of a nationwide Anti-trust investigation, Dairy Farmers of America (DFA) now faces perhaps an even more terrible, swifter sword: a worried investment community.

DFA's members should prepare for deducts against their milk checks.

Diversion of members' milk payments is needed to protect the heavily indebted cooperative's lenders, according to a major financial ratings firm.

DFA's financial condition is drawing serious concern and scrutiny in the financial community. During 2004, DFA's financial performance was impaired by:

- Losses from reduced inventory values of volatile dairy commodities.
- Very poor returns from joint ventures.
- Failure to assess members' milk checks, in order to maintain DFA's lenders' mandated liquidity levels.

Moody's Investors Services, Inc. (Moody's) announced on December 16, 2004 that it is reviewing several of DFA's debt offerings for a possible downgrade. Moody's is a leading firm that evaluates borrowers' credit worthiness. Statements by Moody's during the second half of December expressed concerns that DFA's failure to dock members' milk checks comprised a failure of its covenants to lenders to maintain certain liquidity levels.

(*The Milkweed* quotes from Moody's documents with permission from the firm.)

Five times in four paragraphs of the December 16 release that announced the financial review, Moody's referred to the need for DFA to reduce members' payments for milk.

And the December 21 Moody's release regarding a "Credit Opinion of DFA" questioned DFA's failure to deduct money from members' milk checks. (See quoted material in box, this page.)

(Note: What New York City financial experts label "a relatively small payment reduction" could look like an awfully big deduct to DFA members.

"In a stress situation, DFA's Board could theoretically elect to restrict payments to members in order to conserve cash for debt service. In fact, the cooperative's bylaws dictate that payments to third party creditors, including debt service, have seniority over payments to members for milk. And given the large volume of milk and member payments that flow through the organization weekly, a relatively small payment reduction could quickly generate a significant amount of cash. But although the ability of DFA's

Board to reduce member payments for milk has long been a critical rating factor, it has not appeared to have helped the cooperative sustain its debt protection during this difficult period. Moody's believes that internal political pressures limit DFA's ability to make more than a limited or temporary reduction, even under a stress situation. This calls into question how robust this element is – in practice – in enhancing DFA's financial flexibility."

— *Moody's Investors Services, Inc., Dec. 21, 2004 release: "Credit Opinion of DFA"*

The Milkweed estimates that a \$.50/cwt. deduction against all DFA member milk for four months would generate about \$100 million—no doubt peanuts to "rich" dairy farmers.)

Moody's cites DFA's leverage as "high" in view of the co-op's debt load and great volatility of its earnings and cash flow during the past several years. Moody's notes that DFA's far-flung joint ventures had netted only about \$5 million during the first nine months of 2004. That poor performance—primarily from impaired fluid milk processing businesses in which DFA jointly partners—was seriously harmed during 2004 by dramatically high consumer prices, Moody's analyzes.

As of September 30, 2004, Moody's estimated that DFA's debt, including Trust Preferred Securities, topped \$840 million.

During 2003, DFA reported sales of \$6.9 billion. In 2003, DFA sold 56.5 billion lbs. of member milk—about one-third of the total U.S. milk supply. Through subsidiaries and joint ventures, DFA also markets significant volumes of non-member milk.

DFA's chickens coming home to roost ...

Here's how Moody's analyzed DFA's financial predicament in its December 21 release:

"The cooperative's ratings also incorporate the commodity nature, volatility and relatively low margins of the fluid milk industry. DFA's earnings were hurt over the past year as highly volatile dairy prices

negatively impacted several parts of its business. For example, DFA suffered losses during 2004 after it acquired large quantities of cheese during periods of short supply and very high prices, only to see those values erode when prices fell precipitously. Additionally, earnings from DFA's affiliate network suffered this past year when high prices compressed margins for certain products sold to retailers at fixed prices, and as high prices resulted in reduced consumer demand for fluid milk."

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December Class III \$16.14; January to Decline

December's federal order Class III (cheese milk) price was placed at \$16.14/cwt., up \$1.25 from November.

December's gain reflects higher cheese prices at the Chicago Mercantile Exchange registered one month earlier. However, a sharp decline in the federal order Class III price will occur for January, reflecting big declines in Cheddar prices at CME during the first half of December. USDA/NASS cheese price surveys that are used to figure the federal Class III price lag CME moves by several weeks.

USDA said the December federal order Class IV (butter-powder) price had been placed at \$13.42/cwt., up 8 cents from the November Class IV.

Moody's: DFA Should Pay Members Less

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Ironically, DFA had helped drive up cash Cheddar prices at the Chicago Mercantile Exchange, earlier in 2004, and then bought hundreds of loads of cheese in mid and late spring to try to hold the CME block Cheddar price at \$1.80/lb. before the market collapsed in late June.

Meanwhile, DFA has invested about \$500 million in fluid milk processing joint ventures whose returns soured during 2004.

Thus, inventory losses on collapsing commodity Cheddar prices ... in tandem with losses in fluid milk processing due to high costs ... became a self-induced, "double-whammy" for DFA's 2004 financial performance. In previous years, DFA's joint ventures have consistently returned between \$40 and \$60 million dollars, in the analysis of *The Milkweed*.

Failure of DFA's joint ventures to infuse the cooperative with profits is doubly painful, because for many years DFA (and its predecessor, Mid-America Dairymen) used joint venture profits to offset annual operating losses of the co-op's core businesses selling raw milk and manufacturing cheese.

Between a rock and a hard place

Sadly, Moody's criticism of DFA's board of directors to "reblend" members' milk checks to build liquidity for the debt-ridden cooperative ignores the fact that DFA has, in the analysis of *The Milkweed*, been consistently ripping-off members' milk incomes through a variety of schemes. That siphoning of members' milk income has, in great part, inspired the current joint federal/state Antitrust investigation that's hounding DFA.

On one hand, Moody's is warning DFA to take money from members' milk checks. But on the other hand, Antitrust investigators are focusing on DFA because so much money has already disappeared from

certain members' milk checks ... among many other alleged misdeeds by the cooperative.

Moody's prescription: milk check assessments

The December 21 statement from Moody's lists actions that DFA must take to improve its financial condition, including:

- 1) Stabilize operating performance
- 2) Strengthen risk management procedures and reduce price volatility
- 3) Establish a credible, near-term leverage program, and
- 4) Bolster debt protection measures "through reduced member payments when necessary."

DFA is over-indebted, under-performing ... and under intense scrutiny from both Antitrust investigators and the financial community. The true returns of DFA's mistaken misadventures are going to become apparent in 2005 ... more quickly than many believe possible. Members and the entire dairy industry should closely watch communications from DFA to its members about the co-op's financial conditions. The party's over. Where has all the money gone.

DFA Buys Keller's Creamery

Continuing on its surprising buying spree (in light of concerns about the co-op's financial condition), Dairy Farmers of America announced in early January that it had acquired full interest in the Keller's Creamery, LP joint venture. Keller's is reportedly the second biggest U.S. producer of butter for retail, foodservice and industrial purposes.

This purchase, along with other recent acquisitions, sees DFA in a "buy mode" at a time when the financial community is increasingly concerned about DFA's poor financial performance during 2004. (See article, page 1.)