The Milkweed



Dairy's best information and insights

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

2019: Turnaround Year … for Dairy's Survivors

by Pete Hardin

The Milkweed views 2019 as a "turnaround year" – when the long-running Depression of farm milk prices will turn upwards. Unfortunately, there'll be some casualties along the way for the dairy producers who've simply run out of financial and emotional strength to continue. Many tough decisions will be made in coming weeks and months. Financial stress extends to certain cooperatives and dairy processors.

How and when tighter current dairy supply-demand will filter through this industry's complex milk pricing system to producers' milk checks is less predictable. How high? *The Milkweed* won't hazard specific guesstimates.

Two black clouds hang over cheese trade

Two black clouds merit advance mention, before previewing 2019's farm milk price situation:

1) **Continuing trade wars** sparked by the Trump administration's imposing 25% tariffs on steel imports and 10% tariffs on aluminum imports in mid-2018. Those metal tariffs led foreign trading partners to counter-impose their own tariffs – which hit our nation's dairy, soybean and pork producers (among others) with serious losses of export sales. In the analysis of *The Milkweed*, the 25% dairy import tariffs imposed by nations such as Mexico and China knocked off $1.50 to $1.75/cwt. from U.S. dairy producers' milk prices for the second half of 2018. And those tariffs further eroded dairy livestock values during 2018's second half. "Lost" cheese sales to Mexico are piling up in U.S. warehouses.

2) Cheese inventories are troublingly high. Cheese uses nearly half the farm milk produced in the United States. Burgeoning cheese inventories are stressing cold storage capacities. The combination of excessive inventories and rising interest rates are stressing some cheese firms' financial condition. Heavy inventories of cheese are stalling improvement in critical, monthly Class III (cheese) milk prices in USDA's federal milk order system. The November 30, 2018 figure for cheese inventories (older than 30 days) was 1.352 billion lbs. – near an all-time record.

Looking ahead, we foresee the nation's milk production significantly slowing down as 2019 progresses. Several factors will pull down our nation's milk output in 2019, including:

• Poor-quality materials to feed dairy livestock in many dairy regions (Midwest, Northeast, and Southeast). Quality forage is scarce. Wet summer and fall weather impaired the nutritional value of much corn silage harvested in the above-mentioned regions.

• Significant numbers of dairy farmers are quitting milk production, either by their own decision or by determination of lenders and suppliers.

• Strong exodus of dairy cattle to slaughter. Normally, when a herd disperses, about 15%-20% of the animals go to slaughter and the rest join other milking strings. But these days, the majority of dairy animals crossing the sale ring are heading to slaughter. As those gals leave milking for hamburger, many are being retired before the intended end of their working careers. They won't make more milk. Nor will the fetuses they're carrying ever be born and start producing milk.

• Large numbers of dairy heifers have been sent to fatten in beef feedlots, instead of being bred for milk production. Longer-term, large numbers of dairy cows and heifers are being bred to beef semen/

• Productivity of crops in 2019 will be impaired by scarce funds for spring planting expenses. Credit for 2019's spring planting expenses could be tougher for some dairy producers to obtain. Some suppliers are still carrying on their books unpaid accounts receivable for 2018's seed, fertilizer and chemicals.

Improving NFDM prices. During the week of January 7, two price indices for nonfat dry milk hit (or exceeded) the benchmark of $1.00/lb. On January 10, the cash price for nonfat dry milk at the Chicago Mercantile Exchange hit $1.0250/lb. That same week, Dairy Market News reported that the high end of its "mostly" price range for Low & Medium Heat nonfat in the West hit $1.0000/lb. What's driving nonfat prices? NFDM sales are strong. For July-October 2018, monthly NFDM production in the United States fell below year-ago totals. Also, Mexico's 25% tariffs were not applied to NFDM, so sales to Mexico have continued strong. The U.S. dairy industry looks poised for continued run-up in NFDM prices during this year. Europe's "mountain" of aged Skim Milk Powder (SMP) has been whittled down.

Butter prices remain strong, November saw an 80 million lb. draw-down of U.S. butter inventories, according to USDA's Cold Storage report issued in mid-December. Unfortunately, no further Cold Storage data will be available fo the duration of the federal government's shutdown, so no data will be available for the year-end butter inventory figures. At CME, cash butter markets remain solid – in the "$2.20-something" price range. That's despite the end of strong, seasonal months of butter sales leading up to the year-end holidays. Slowing milk production in 2019 will mean lesser volumes of cream available for butter plants and other users of cream.

So what's ahead in 2019???

Fewer dairy farms. Fewer milk cows. Reduced numbers of available replacement heifers as 2019 rolls along. Due to poor-quality crops in 2019, predictably less production per cow will take place in areas stretching from the eastern regions of Iowa and Minnesota all the way east to the Atlantic Ocean and down the East Coast to the Carolinas. Large volumes of feed materials harvested in those regions during 2018 are substandard, due to impairment by too much moisture. We foresee reduced productivity of crops on many remaining dairy farms in 2019.

Ironically, Mother Nature is in great part responsible for the slowdown in farm milk output. Nothing … absolutely ***nothing*** has helped better dairy supply-demand during these ruinous four years. In fact, the continuing trade wars have stalled improvement of farm milk prices. The sooner the U;S. government's 25% tariffs on steel end, the sooner cheese prices will start bouncing back and farm milk prices will see all three major commodities – butter, nonfat dry milk, and cheese – provide upwards price propulsion.

See page 2 for Email Subscription details.

Dean Foods: Preparing for Bankruptcy???

"Dean Foods Receivables Securitization Facility* – We have a $450 million receivables securitization facility pursuant to which certain of our subsidiaries sell their accounts receivable to two wholly owned entities intended to be bankruptcy remote. The entities then transfer the receivables to third-party asset-backed commercial paper conduits sponsored by major financial institutions. The assets and liabilities of these two entities are fully reflected in our unaudited Condensed Consolidated balance sheets, and the securitization is treated as a borrowing for accounting purposes." *(Red color enhancement added.)

Source: Dean Foods' late 2018 10-Q filing, page 19

by Pete Hardin

"BANKRUPTCY REMOTE"???

What in Sam Hill does that mean?

Senior management appears to be prepping Dean Foods – the nation's largest fluid milk processor — for a bankruptcy filing. How? By burying up to $450 million of "accounts receivable" into wholly owned subsidiaries, and then selling those receivables as "third-party asset-backed commercial paper conduits sponsored by major financial institutions."

Sounds like Dean Foods' current management has cooked up an Ivy League MBA scam to shaft suppliers and lenders by hiding up to $450 million in liquid assets beyond the supposed reaches of the bankruptcy process.

The above-cited quote from Dean Foods late 2018 10-Q report details what looks like strategic corporate foreplay heading towards a full-blown, involuntary screwing of many of the company's suppliers (like dairy farmers) and creditors. According to the 10-Q filing, "major financial institutions" are party to this scam.

"Accounts receivable" are the funds due to Dean Foods from the sale of its products to buyers. As the nation's biggest fluid milk processor, Dean Foods' accounts receivable are primarily derived from the sale of consumer dairy products – milk, ice cream, yogurt, etc. Thus, firms supplying materials such as raw milk and cream could be vulnerable in a possible bankruptcy declaration by Dean Foods.

In 2017, Dean Foods reported annual sales of $7.5 billion, or approximately $600 million per

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Dean Foods: Profitable Units Sold to Cover Engle$-Era Debts

by Pete Hardin

Dean Foods roared to its top spot as the nation's biggest fluid milk processor in late 2001 using "pre-Great Recession" strategies straight out of then-prevailing Ivy League business school text books: Borrow lots of money and over-pay for competitors.

Dean Foods was created by merger of the nation's two largest fluid processors in December 2001.

That Ivy League M.B.A. mentality was personified in Dean Foods' then president and CEO, Gregg Engle$*. In early 2007, at the peak of the debt-driven, "pre-Great Recession" financial follies, Dean Foods borrowed $1.96 billion to pay out a $15/share, one-time stockholder bonus. Engle$ personally pocketed about 40 million of that $1.96 billion as his share of the $15/share pay-out. Debt. Debt. And more Debt.

At one point, *The Milkweed* estimated that Dean Foods was carrying over $6 BILLION in debts while annual sales volume totaled around $12 BILLION. In a low-margin industry such as fluid milk processing, posting debts equal to roughly half of annual sales volume was a precarious spot. And then Dean Foods' margins turned increasingly sour in recent years.

* *The Milkweed* spells the last name of the former Dean Foods' CEO as Engle$. Gregg is certainly no descendant of Friedrich Engles.

Several years ago, Engle$ bolted from Dean Foods – taking with him the company's most profitable subsidiary, White Wave – a packaged food and beverage company. Selling off White Wave was part of a strategy to reduce Dean Foods' burdensome debt by shucking profitable subsidiaries. Trouble was: by the time Dean Foods had diligently worked down its debts to the current level of approximately $890 million, virtually all the profitable subsidiaries were gone.

Then Dean Foods' single largest buyer of fluid milk – Walmart – turned nasty. Walmart's late spring 2018 opening of that company's first fluid milk processing plant (at Fort Wayne, Indiana) forced the closings of several Dean Foods' plants located within a radius of several hundred miles of Fort Wayne. Walmart (the acknowledged "low-cost leader") had been playing Dean Foods like a fiddle – buying large volumes of packaged milk but paying scant margins to suppliers. Walmart priced Dean Foods' private-label gallons as much as $2.00 apiece higher than Walmart's store brands – even though the store brands and Dean Foods' labeled product were both packaged and distributed by the same firm — Dean Foods.

In mid-2018, Dean Foods announced closings of a half-dozen or so fluid milk plants, effective later that year. Trouble was: the logistics of multiple plant closings overwhelmed Dean Foods' day-to-day operations. In mid-September 2018, the *Boston Globe* reported Dean Foods failure to deliver packaged milk to supermarkets and schools in Massachusetts. That paper noted how the Springfield school district had to send its own trucks to Dean Foods' Franklin plant to get half-pints of milk needed for school meals! More recently, in northwestern Pennsylvania and surrounding areas, competing dairy firms reported to *The Milkweed* that supermarkets were being told by Dean Foods to "call another processor" if they wanted milk. Seems that Dean Foods shut-down of its Erie, Pennsylvania facility has been compounded by problems retaining drivers to deliver products to stores, schools and institutions.

This past year, Wall Street has not suffered any fools, including Dean Foods. Investors have unmercifully pounded Dean Foods' stock. In January 2017, Dean Foods' stock was pegged at over $22 per share. But by late December 2018, Dean Foods' stock had fallen down into the $3.70 range – a decline of just more than 80%. Perhaps acknowledging that Dean Foods stock had eroded too low, investors pushed up the company's stock in early January 2019 … at least temporarily.

Even so, some parties in the dairy industry expect a bankruptcy filing by Dean Foods in 2019. The company's most recent 10-Q filing acknowledges that up to $450 million in receivables are being squirreled away in "bankruptcy-remote" woodchuck holes. (See accompanying article, page 1.) Suppliers beware … That's *The Milkweed's* bottom-line analysis after viewing Dean Foods' most recent 10-Q filing.

A Few Facts about Dean Foods' Operations …

by Pete Hardin

The Milkweed has gleaned the following facts from the May 9, 2018 Credit Opinion issued by Moody's Investors Service that help depict Dean Foods' overall financial profile somewhat more fully.

Annual Sales …

As the company has whittled down its operations by selling off certain businesses, annual sales have trended down:

2013	$9.0 billion
2014	$9.5 billion
2015	$8.1 billion
2016	$7.7 billion
2017	$7.8 billion
2018	$7.0 billion (projected)
2019	$6.7 billion (projected)

2017 Sales by category …

For the fiscal year that ended December 31, 2017, here's a breakdown of Dean Foods dairy product sales by category:

Fluid milk	68%
Ice Cream	14%
Fresh Cream	5%
Cultured Products	4%
Other Beverages	4%
Extended Shelf Life	2%
Other	2%

Annualized volume declines (All products) …

The following data demonstrate volume declines (compared to the previous year) at Dean Foods. These figures are calculated based upon annual gallonage sales:

2014	-3.5%
2015	-3.1%
2016	-2.1%
2017	-4.2%
2018	-5.7% (projected)

Overviews …

• In 2017, Walmart was Dean Foods' single largest customer – commanding about 17% of Dean Foods' overall sales.

• In 2017, approximately 51% of total revenue was derived from sales of private label products, which yield lower profit margins than branded Dean Foods products. Dean Foods operating profit for calendar/fiscal 2017 was 2.3% — described as "low." •

Operating profit margins are anticipated to remain low during 2018 and 2019.

• Prior to the recent spate of plant closures, Dean Foods held approximately one-third of all fluid milk sales nationally. That volume places Dean Foods at approximately five times as large as its nearest competitor.

Liquidity & Rating Outlook …

Moody's Investors Service updated its Credit Opinion of Dean Foods on May 9, 2018, following a downgrade of Dean Foods rating to B2. Moody's noted volatile earnings and cash flow, moderately high fiscal leverage, and disruptions in the company's operations as it pursued plans to close several processing plants.

Moody's praised Dean Foods' large-scale distribution network and refrigerated direct store delivery capabilities.

However, Moody's 5/9/18 credit opinion of Dean Foods bears a few tripwires:

• Moody's noted that its ratings outlook was contingent upon maintaining high financial leverage and **...** "**adequate liquidity**" (a critical phrase).

• Factors that could lead to a further downgrade would include:

—Profitability declines. (Note: Dean Foods lost money in 2018's fourth quarter).

—Liquidity weakens. On the subject of liquidity, Moody's stated on 5/9/18, 'We expect the company to remain in compliance with these financial covenants over the next twelve months. (In its early November 2018 call with financial analysts, Dean Foods personnel implied that the company had fallen behind on meeting its covenants with lenders and restructured those arrangements through June 2019.)

Is Moody's liquidity analysis ignoring "bankruptcy-remote" receivables?

Moody's 5/9/18 analysis was issued ***after*** Dean Foods had commenced shifting receivables "of certain of our subsidiaries" to wholly-owned subsidiaries

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Dean Foods: Preparing for Bankruptcy???, con't

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month. But since fluid milk processors' accounts receivable normally turn over every two weeks to monthly, that $450 million in accounts receivables – if a monthly figure – could equate to a high percentage of Dean Foods' monthly sales. In other words, Dean Foods has squirreled away from the clutches of the bankruptcy process accounts receivable equal to a high percentage of its monthly sales volume.

Which subsidiaries of Dean Foods are engaged in this accounts receivables sham? And what "major financial institutions" are complicit in this scam?

Potential devastating impact on suppliers

For firms supplying products and goods to Dean Foods, the impact of a bankruptcy in which assets such as accounts receivable were held at bay from the bankruptcy process would be devastating. Major suppliers would include sellers of raw milk and packaging materials (plastic for gallon jugs and paper wares for milk cartons and ice cream containers).

Let's focus on independent dairy producers and milk cooperatives selling farm milk to Dean Foods. Some states provide programs to "secure" raw milk sales by individual producers and cooperatives. However, those state programs generally extend only to sales of farm milk to in-state dairy processors. In other instances, where farm milk travels across state lines – such as from Wisconsin to Illinois, or New York State to Massachusetts – state milk security programs do not apply to raw milk and cream, sellers beware.

If and when suppliers of packaging materials comprehend Dean Foods' "bankruptcy-remote" strategy, those firms will likely put Dean Foods on a "cash-only" basis.

Why?

Industry sources question why Dean Foods would put in place a contingency to isolate up to $450 million of accounts receivable as "bankruptcy-remote" unless the firm were planning to use that tool.

Sources say that Dean Foods' early November conference call with investment advisors noted that the firm had restructured its covenants with lenders. Those covenants are now in effect through the end of June 2019. Implicitly, prior to the restructuring, Dean Foods had strayed outside the parameters of those covenants with the firm's lenders.

Even with the restructuring of financial covenants in late 2018, one source raised doubts that profitability levels for Dean Foods during 2018's fourth quarter and 2019's first half would be adequate to comply with new covenants. The specter of rising costs for fluid milk during 2019's second quarter should raise concerns about Dean Foods' profitability during that quarter.

The company continues struggling with plant closings and consolidations. During the second half of 2018, Dean Foods closed seven dairy processing plants. The firm's single largest customer for packaged fluid milk – Walmart – opened its own fluid milk plant in mid-2018 – a factor forcing several of the Dean Foods' plant closings.

Wall Street investors have pounded the stuffing out of Dean Foods' stock value. In recent weeks, Dean Foods' stock has groveled around the $4 per share mark – a far cry from the $22-plus per share mark just two years ago in early January 2017.

The spectre of the nation's largest fluid milk processor taking steps to isolate a major portion of its subsidiaries' accounts receivable from the bankruptcy courts is scary.