

The Milkweed

Dairy's best marketing info and insight

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Moody's Says DFA 'Weak,' Lowers Credit Ratings

by Pete Hardin

On May 9, 2005, Moody's Investors Service (Moody's) issued revised, downgraded ratings for various types of borrowings by Dairy Farmers of America (DFA). Four separate times in the text of Moody's announcement, the financial ratings firm referred to various aspects of DFA's finances and management as "weak."

DFA's financial instruments are now rated as "junk" by Moody's.

The Moody's review came almost five months after Moody's announced a 90-day review of DFA's financial condition on December 21, 2004. No doubt, Moody's found the sludge at the bottom of DFA's financial pot a lot thicker than originally believed.

Moody's downgraded DFA's senior unsecured rating from Baa1 to Baa2 and downgraded ratings on trust preferred securities of guaranteed subsidiaries from Baa2 to Baa3. DFA's preferred stock was downgraded from Ba1 to Baa3.

In summary ...

Moody's updated May 9 analysis found:

- Debts exceeding \$950 million. DFA's borrowings have risen \$195 million in the past two fiscal years.
- Low cash flow relative to debt load.
- Failure to take enough money from members' milk checks to protect lenders.
- "Earnings" from equity affiliates that dramatically overstated actual cash received.
- Weak management.

Read it yourself!

Perhaps most telling is the tough language used by Moody's in detailing its revised ratings for DFA. The Milkweed quotes some passages from Moody's May 9, 2005 analysis of DFA:

"The downgrade of DFA's ratings reflects (1) DFA's higher debt levels as it assumes financing

for affiliates which previously financed themselves independently; (2) continuing weak debt protection measures for a Baa1 rated credit; (3) the increased business risk profile of the cooperative as branded dairy food and the handling of non-member milk become a larger component of sales and earnings; (4) and the cooperative's unwillingness to scale back member payments of the past year to make up for poor fundamental operating performance.

"DFA's leverage is high in light of its debt load, and the greater volatility of its earnings and cash flow witnessed over the past several years. As a result, the company remains weakly positioned within its new rating category. DFA's debt and debt-like instruments have increased steadily over the past few years, rising approximately \$195 million between year ends 2002 and 2004. The 2005 consolidation and refinancing of an affiliate—Mid-Am Capital, LLC—as well as the acquisition of Kellers Creamery will add incremental debt to DFA's balance sheet (above and beyond Mid-Am debt previously issued under a support agreement and included in Moody's leveraged calculations.) Additionally, Moody's views as 100% debt-like DFA's \$375 (million) and in trust preferred securities and \$150 million in preferred stock due to provisions in these agreements which reduce the equity-like features of these instruments. As a result, DFA's pro-forma and debt-like instruments exceeds (sic) \$950 million. We note, however, that increased dividends from affiliates or redemption of investments in affiliates in 2005 could bring this debt number down somewhat. Regardless, DFA's cash flow is low in relation to this debt load. The cooperative regularly pays out the majority of its cash to members in exchange for their milk with the goal of payout at the highest possible price. Additionally, the earnings DFA reports from affiliates greatly exceed the amount actually received as cash dividends. As a result of these factors, retained cash flow (excluding extraordinary gains from asset sales) represents less than 7% of debt and debt-like instruments—which is

very weak for a Baa2-rated credit in a volatile business. DFA will need to stabilize its operations and reduced its debt load in the near term if it is to sustain its Baa2 rating.

"Moody's believes that DFA's business risk has increased over the past few years, and that management's ability to adapt to these changing risks has been weak. Historically, DFA's price risk was limited as it served simply as a conduit through which members' milk was aggregated and delivered to processing plants, with member dairy farmers absorbing price fluctuations. However, as DFA's investments in bottling affiliates has (sic) increased and its branded dairy foods business has increased, its earnings have become more sensitive to the overall pressures impacting the dairy foods and bottling businesses. For example, over the past year, DFA's earnings from bottling affiliates was negatively impacted by a sharp run-up in milk prices which resulted in reduced consumption and lower bottler

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April Class III at \$14.61; CME Moves Still Strange

The April federal order Class III (cheese milk) price was placed at \$14.61/cwt., up 53 cents from March.

USDA's latest Class III value for the federal milk marketing orders reflects the continued weirdness at the Chicago Mercantile Exchange, where cash Cheddar values have risen and fallen on monthly cycles throughout 2005. USDA's Class III price is not directly tied to CME, but the market does greatly affect values. Given the seemingly nonsensical price cycles, it is difficult to forecast Class III values very accurately over a period of even a month or two, let alone for the rest of 2005.

USDA said the April federal order Class IV

Moody's Downgrades DFA's Credit Rating

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earnings—and hence lower core earnings at DFA. Additionally, as branded dairy food manufacturing has become a larger business at DFA, the cooperative must respond to its market to protect its market share. When certain dairy products appeared in short supply in early 2004, DFA entered the market and acquired large quantities of raw dairy materials so as not to run short and disappoint customers. When prices for those materials fell precipitously, DFA incurred large inventory losses. This event not only highlighted the increased price risk that DFA's business now faces, but also the cooperative's poor risk management and hedging ability. While DFA has made changes to its risk management practices which it hopes will prevent a recurrence of such an event. Moody's continues to view this increased business risk and the greater earnings volatility it has created as a concern....

“DFA's ratings gained some support from the financial flexibility afforded by its cooperative structure. In a stress situation, DFA's Board could elect to restrict payments to members in order to conserve cash for debt service. Its bylaws dictate that payments to third party creditors, including debt service, have seniority over payments to members for milk. Accordingly, the pool of funds available to service obligations is theoretically large. Given the large volume of milk and member payments that flow through the organization weekly, a relatively small reduction could quickly generate a significant amount of cash. Still, Moody's believes that competitive markets and internal political pressures would limit DFA's ability to make more than a limited or temporary payment reduction, even under a stress situation. This was highlighted over the past year, when DFA experienced weak fundamental operating performance, but chose not to scale back on member

payments sufficiently to make up for the shortfall from its base business. For this reason, Moody's no longer views DFA's cooperative structure and ability to reduce member payments as significant a credit positive as it did in prior years. In general, Moody's now believes that under normal circumstances, DFA is unlikely to reduce member payments by more than 1%. It is Moody's practice in evaluating agricultural cooperatives to adjust credit metrics to reflect the ability and willingness to reduce member payments. In DFA's case, we will add back no more than 1% of member payments to reflect this benefit.”

Chickens coming home to roost

In conclusion, Moody's contradictorily lists DFA's new credit ratings as “stable.” But Moody's leaves the door open for further downgrades if the co-op experiences weak financial performance, or leverage increases due to high member payouts or continued equity payouts that exceed new equity paid by members. Moody's also seemingly warns against new investments by DFA or its equity affiliates.

No wonder DFA CEO/President Gary Hanman has been in a foul mood lately

Standard & Poor's: 'DFA Taking More Each Month From the Farmer's Milk Check'

by Pete Hardin

Don't worry about DFA's finances. DFA is “taking more each month from the farmer's milk check,” according to a recent report by a leading financial analysis firm.

Standard & Poor's, a firm that rates the credit-worthiness of borrowers, issued on April 25 an updated financial analysis for Dairy Farmers of America. Standard & Poor's discussed the challenges facing DFA's profits, due to higher milk prices ... and DFA's “solution” (dock members' milk checks).

Ironically, there's only one source from which Standard & Poor's could have confirmed that DFA was deducting more money from DFA member milk checks—DFA's senior management!

Standard & Poor's analysis of DFA's financial condition is one paragraph—far less verbiage than what Moody's Investors Service reported in December 2004. In two separate, critical reports about DFA's financial condition, Moody's noted that in order to stabilize risks for DFA's creditors, the co-op had to deduct money from members' monthly milk

“Dairy Farmers of America's (DFA) business and financial strategies are expected to help maintain credit measures commensurate with the current ratings. In 2004, members/owners benefited from very high raw milk prices but this has squeezed margins in DFA's further processing operations, resulted in cheese inventory write-downs, and affected operating profits. The cooperative took steps (curtailed capital expenditures). However, management did takes steps from mid-year through the present because of the high milk prices in cutting expenses such as curtailing capital expenditures AND TAKING MORE EACH MONTH FROM THE FARMER'S MILK CHECK. Standard & Poor's expectations is (sic) that milk prices should be at more normalized levels in 2005.”

— Standard & Poor's, April 21, 2005. (Capitals added for emphasis.)

Angry Members Disrupt