Testimony on Dairy Farm Operating Trends and the Impact of Proposed Pricing Changes

Introduction

My name is Leland Kootstra, and I am a Partner at Frazer, LLP, a full-service accounting and consulting firm. We work closely with hundreds of dairy producers across the United States, with a heavy focus on providing consulting services to these producers.

Founded in Chicago in 1917, Frazer, LLP expanded throughout the Midwest and Eastern United States. During the 1950s, we began working closely with dairy producers, finding our niche in this industry. Following the westward movement of many producers, we opened offices in California, where we are headquartered today. We serve over 200 dairy producers across more than twenty states, and I am proud to say that my office is in Tulare County, the nation's leading milk-producing county. We continually strive to be our clients' most trusted advisor, offering services ranging from traditional tax and assurance work to lender negotiation, estate planning, and transactional support services.

Background

I joined Frazer in late 2011 after graduating from Point Loma Nazarene University with a Bachelor of Science degree in Accounting. Immersed in the dairy industry, I quickly developed an appreciation for the incredible work that goes into producing and supplying high-quality milk products to the world. My experience includes working closely with many producers and processing companies in navigating challenging business cycles, exploring new opportunities, evaluating risk, and developing business models.

Today, I have been asked by the National Milk Producers Federation to provide an overview of our Dairy Farm Operating Trends Report, including the information contained therein, and to answer any questions you may have.

Dairy Farm Operating Trends Report

The Dairy Farm Operating Trends Report is a resource provided by Frazer to our clients, lending institutions, and the larger dairy industry. Available for free on our website, this report is organized by geographic regions in the United States and presents financial performance for the year presented. The most recent report, with a balance sheet date of December 31, 2022 presents operations across 8 regions, including Southern California, the San Joaquin Valley, Kern County, Arizona, Idaho, New Mexico, Panhandle, and the Pacific Northwest.

The contents of the report are prepared using client data from compiled, reviewed, or audited financial statements prepared in accordance with Generally Accepted Accounting Principles (GAAP). To protect clients and ensure the report's reliability, all personal and identifying data is anonymized. We carefully select representative dairies for inclusion, excluding those undergoing significant changes or transitions that could materially impact the report's usefulness.

For more than two decades, Frazer, LLP has prepared the Dairy Farms Operating Trends Report, assisting dairy producers and lenders in evaluating specific herd performance. However, it's essential to recognize that the data presented may not be exhaustive or inclusive of all dairy business models. For instance, the report mainly represents larger scale dairies in the Western United States. A dairy producer located in Florida, for example, would be better served to compare their operations to a benchmark study more heavily focused on the Southeast.

Key Findings and Financial Performance

The report presents financial results and metrics in multiple ways, explaining trends within the report. When examining several iterations, readers can identify significant trends and the impacts of changing economic environments on financial performance.

I have included a snapshot of the financial performance for a dairy operation in the Panhandle during four significant years in the dairy industry: 2009, 2014, 2020, and 2022.

	2009	2014	2020	2022
Net Income, Per Head	$ (799)	$ 1,250	$ 1,275	$ 436
Feed Cost, Per Head	$ 1,920	$ 2,313	$ 1,991	$ 3,124
Milk Production Per Cow, Per Day	61.80	68.90	67.60	66.20
Herd Turnover Rate	29.30%	37.90%	40.60%	32.50%
Cost of Replacements	$ 1,448	$ 2,549	$ 926	N/A
Milk Sales, per Cwt	$ 13.63	$ 23.85	$ 22.49	$ 25.45
Feed Cost, per Cwt	$ 9.09	$ 10.79	$ 8.21	$ 15.09
Labor Cost, per Cwt	$ 1.65	$ 1.65	$ 1.82	$ 2.24
Herd Replacement Cost, Per Cwt	$ 1.90	$ 0.67	$ 1.67	$ 1.20
Interest Expense, Per Cwt	$ 0.65	$ 0.37	$ 0.37	$ 0.33
Current Ratio	0.59 :1	1.35 :1	2.21 :1	1.02 :1
Debt Per Cow	N/A	$ 747	$ 563	$ 575
Total Debt Per Cow	$ 1,831	$ 2,667	$ 2,658	$ 2,740
Debt to Equity Ratio	4.01 :1	1.06 :1	0.96 :1	0.86 :1
Return on Total Assets	-15.20%	16.60%	14.30%	5.40%
Income/Loss Per Cwt	$ (3.73)	$ 5.83	$ 5.94	$ 1.65
Income/Loss Per Milking Cow, Per Mo	$ (61.10)	$ 129.99	$ 107.43	$ 42.46

These years stand out for various reasons:

- **2009**: Most dairies in the United States incurred losses due to depressed milk prices.
- **2014**: Producers enjoyed profitability due to high milk prices and comparatively low feed expenses.
- **2020**: Mixed results were seen, with the Panhandle experiencing a profitable year while other regions faced losses. Class III & Class IV Milk prices, historically close to parity, saw a spread of more than $10.00 per cwt at points during the year.
- **2022**: The industry enjoyed historically high milk prices but also endured historically high feed prices as well.

I highlight these years to underline key aspects related to the profitability and feasibility of dairy operations, especially in the context of the proposed pricing changes. While the milk price is undeniably the most significant contributor to top-line revenue for dairies, it's far from the only influential factor. For instance, feed costs, comprising over 60% of a dairy's cost structure, have seen remarkable fluctuations in recent years. These variations stem not only from supply chain challenges but also from political conflicts, weather patterns, and other external conditions.

Dairies have often absorbed the impact of inflation, interest rate increases, and the rising costs associated with labor and environmental regulations. Concurrently, consumer demand for more sustainable, safe, and quality products has put additional pressure on the industry. While this has led to enhanced efficiency and improvements in dairy operations, it has also incurred substantial costs and required significant investments.

As reflected in the table above, this complex scenario extends beyond mere annual income statement performance. It reveals an increase in the average debt held by a producer per cow, encompassing both operating and other debt, often related to facilities and real estate. Specifically, from 2009 to 2022, the average debt per cow more than doubled, a trend consistent across regions, not just in the Panhandle. This increase in debt illustrates that while dairy producers have invested immense time, energy, and resources to elevate operations and herd performance, this growth has predominantly been debt-driven. With the recent surge in interest rates over the past 18 months, this debt accumulation adds a substantial additional burden to the cost of dairy production.

Considerations for Proposed Changes

Dairy producers are predominantly price-takers, meaning that although they have access to some risk management tools, they typically cannot set their milk price based on production costs. This leaves them vulnerable to the volatility of the commodity market. The dairy industry has seen periods of both healthy and negative margins, even as operations have remained relatively consistent. As outlined in the Dairy Operating Trends Reports, the average financial statement margin per hundredweight produced over the past decade is less than $1.00, or approximately 4-7% of the average milk price during that time frame. With the ongoing rise in costs, the milk price necessary to maintain a positive and financially sustainable margin must support these additional costs. If it fails to do so, we can expect continued and significant consolidation within the industry.,.

Closing Comments:

As we contemplate changes to Make Allowances and the Class I Mover pricing mechanisms, it is essential to understand the delicate balance of costs, revenues, and market forces that shape dairy operations. Any overly aggressive reduction in milk price could have long-term, irreparable effect on many dairy producers' financial positions, expediting consolidation of the industry. I implore you to evaluate the impact on dairy producers carefully, recognizing the critical role that dairy producers play in our economy, their communities, and our daily lives.

I will now take any questions you may have. Thank you.