January 31, 2007

MCT COMPASS

A complimentary service of MCT Dairies, Inc.• www.mctdairies.com

Another Unintended Consequence

There is no denying that 2007 was a financially challenging year for cheese manufacturers. Most are aware of the negative impact that rising whey values had on cheese milk prices. The California Department of Food and Agriculture decided that the record whey values were so disruptive to its cheese industry that it capped the value of whey in the California 4b price at 25 cents per hundredweight. That converts into a dry whey value of 30 cents per pound.

Within the Federal Milk Marketing Orders, no decision has been made on changing the whey value in the Class III price calculation. And, even if a recommended decision were to be made in the next month, it would be followed by a comment period, a final decision, and then the vote. Needless to say, it's unlikely that cheese makers in the Federal Order system will experience in 2008 the type of financial relief given to California processors recently. Fortunately, for some, the dry whey price has returned to a price level closer to the historical norm.

Perhaps even more challenging to a cheese maker is the disconnect between the Class III milk price and the Chicago Mercantile Exchange (CME) cash cheese market. The Class III milk price is derived from a product price formula. The product price formula inputs USDA surveyed prices of 40-lb. block Cheddar cheese, 500-lb. barrel Cheddar cheese, bulk butter, and dry whey into an equation to calculate the value of milk used to produce those products. By using USDA surveyed prices rather than CME prices, there is a disconnect built into the regulated milk price.

Chart 1 (page 2) illustrates that the gross margin has narrowed since 2003. The gross margin analysis is a useful tool, or financial barometer, to determine the well being of cheese manufacturers. The gross margin analysis is based on the price a cheese manufacturer sells its product for minus the cost of the input (milk).

Since a cheese manufacturer produces about 10 lbs. of Cheddar cheese from 100 lbs. of milk, the milk price is divided by 10. Historically, when a cheese maker had a margin of 10 cents, it was doing well. In other words, if the CME block market was $1.50/lb. and the Class III milk price was $14.00/cwt., the gross margin would be 10 cents per pound (($1.50 – ($14.00/10)) = $0.10/lb.

The current trend is not the cheese manufacturer's friend. In

Continued on page 2

KEN'S CORNER

by Ken Meyers
President
MCT Dairies Inc.

Cheese manufacturers face enough challenges in the marketplace that it is unfortunate that the regulated milk pricing environment puts cheese makers at a regional and product-mix disadvantage.

It is imperative that both dairy farmers and dairy processors work off of the same market signals and not those that are distorted because of lags in reporting and the exuberant by-product markets.

In a period when milk production is growing by 2% to 3%, growth in American cheese output should mirror milk production growth, not decline by 1%.

There is a great opportunity to supply our domestic market as well as growing global markets. Let's not let the regulated milk pricing system impede our ability to compete domestically and globally. MCT

MCT Forecast

	Block*	Barrel*	Butter*	Whey**	NFDM**	Class III	Class IV
Jan	1.8250	1.8775	1.2250	0.4000	1.430	19.35	16.20
Feb	1.7350	1.7350	1.2500	0.3200	1.375	16.85	15.55
Mar	1.6850	1.6750	1.3400	0.3400	1.320	16.10	15.35
Apr	1.6750	1.6550	1.3250	0.3500	1.315	15.95	15.00
May	1.6500	1.6300	1.3375	0.3600	1.370	15.80	15.50
Jun	1.6500	1.6300	1.4000	0.3700	1.420	15.85	16.00

** Block, barrel and butter are monthly averages of CME prices.*
***Whey and NFDM are monthly averages of NASS prices.*

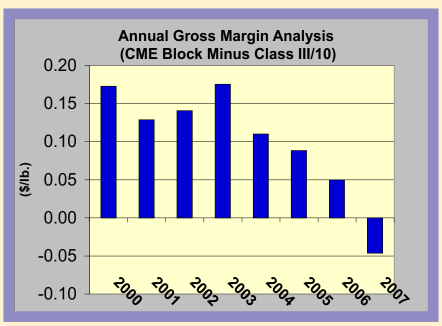
Excitement Ahead

Both milk production and the dairy herd are expected to grow into the second quarter of this year. However, $5/bu. corn and $12/bu. soybeans, not to mention $200/ton dairy alfalfa, are expected to take their toll on producer margins and milk production. Add the possibility that a herd reduction sponsored by CWT (Cooperatives Working Together) will occur and the outlook for 2008 is anything but boring. MCT

Marginal margins...

Continued from page 1

2005 and 2006, the gross margin was less than 10 cents per pound, and in 2007, it was a negative nickel per pound. The second chart (top right) illustrates that the gross margin during most months in 2007 was negative. American cheese



Source: MCT Dairies, Inc.

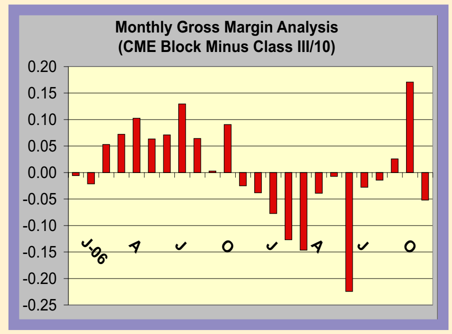
manufacturers responded to their economic plight by producing about 1% less cheese in 2007.

Lower cheese production led to lower inventory build. Commercial stocks of American cheese peaked in April 2007 at 582.1 million pounds and have declined steadily since. The prior two years, stocks peaked midyear at nearly 603 million pounds.

Lower production and lack of inventory build has in turn contributed to the negative margins and to volatility in the CME Cheddar block cheese price. The last chart (bottom right) illustrates that our key dairy market has resembled Idaho's Sawtooth Mountains since June 2007.

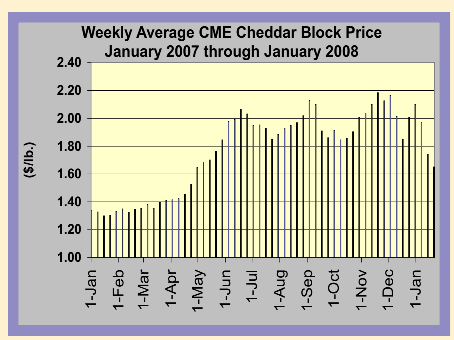
The disconnect between the Class III price and the CME cash cheese market is due in part to using NASS surveyed prices and it also contributes to negative gross margins. The NASS cheese price is highly correlated to the CME markets during the last two weeks of the preceding month and the first two weeks of the current month. For example, the January Class III price announced Feb. 1, 2008, is expected to be near $19.30/cwt. Cheese manufacturers sense by mid-month of the current month what the Class III price will be.

When the CME Cheddar block price tumbled to $1.65/lb. on Jan. 18, cheese manufacturers prepared for another month of negative margins by producing as little cheese as possible and pushing January sales into February. Unfortunately, the decision to produce less cheese during the second half of January is driven by the unprofitable situation between the



Source: MCT Dairies, Inc.

regulated milk price and the current cheese market. As a result, two to three weeks after the decrease in production, the cheese supply pipeline is likely to be tight again, which could force the market higher. This ebb and flow during 2007 contributed to the Sawtooth cheese prices experienced in 2007. Sorry to say the pattern appears to be continuing into 2008.



Source: MCT Dairies, Inc.

 MCT Dairies, Inc., 15 Bleeker St., Millburn, NJ 07041 (973) 258-9600 fax: (973) 258-9222 www.mctdairies.com. For more information, email **info@mctdairies.com.**