First Capitol Risk Management

Dairy Margin Management

HEDGING STRATEGIES FOR CALIFORNIA DAIRIES

Modesto December 6, 2010

Tulare December 7, 2010

First Capitol

Risk Management

Agenda

- About Us
- Margin Management
  - Challenges
  - Decisions
  - Steps
- Moving Forward

First Capitol
Risk Management

About Us

- Leaders in the Dairy Futures Market since its inception
- Dairy Risk Management Services include:
  - Education
  - Consulting
  - Futures & Options Brokerage
  - Full Service Margin Management Program
- Serving Dairy Clients from our Offices in Illinois, California and Texas
- Dairy Clients include Producers, Processors and End-Users of Dairy Products

First Capitol
Risk Management

Agenda

- About Us
- Margin Management
  - **Challenges**
  - **Decisions**
  - **Steps**
- Moving Forward

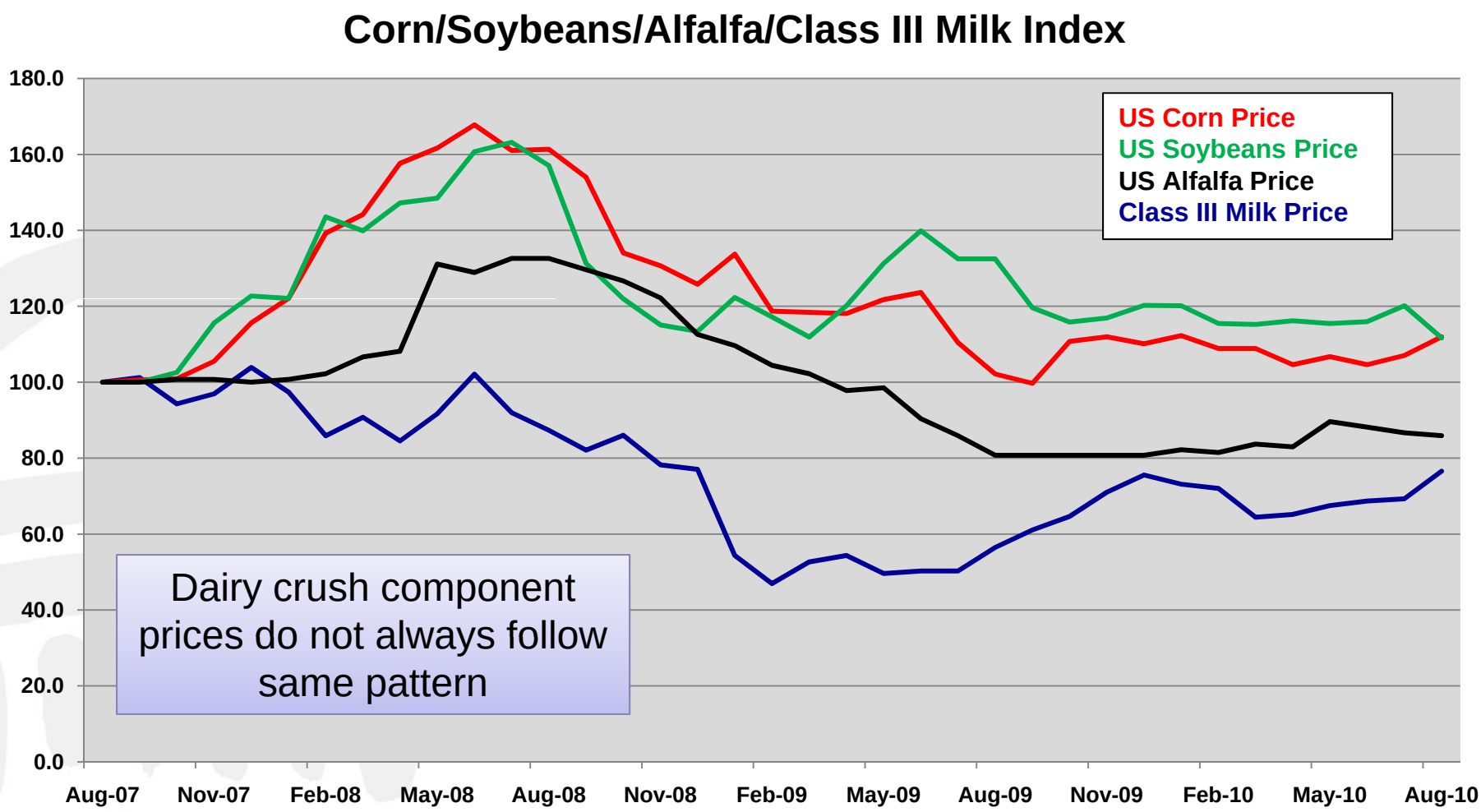
First Capitol
Risk Management

Challenges

- Milk Price Volatility
- Feed Price Volatility
- Currency Volatility
- Policy Uncertainty
- Local & Global Competition
- Credit Contraction
- Margin Compression

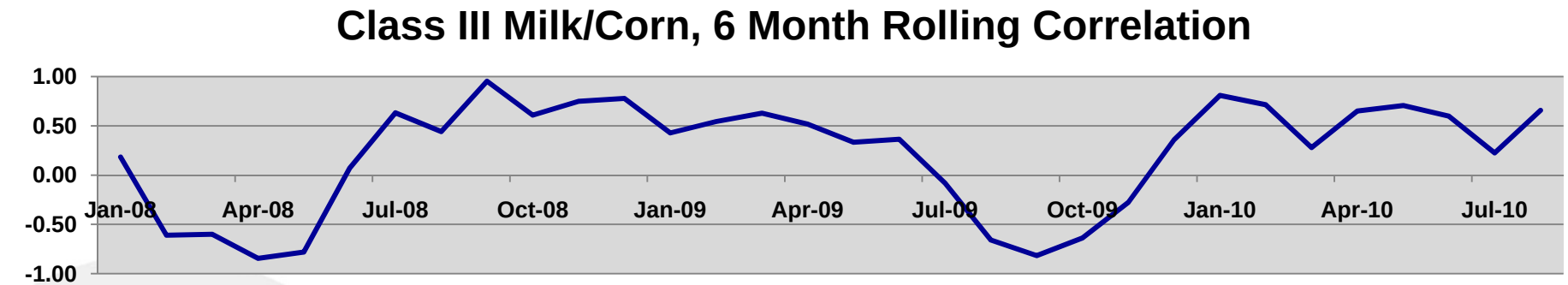
First Capitol
Risk Management

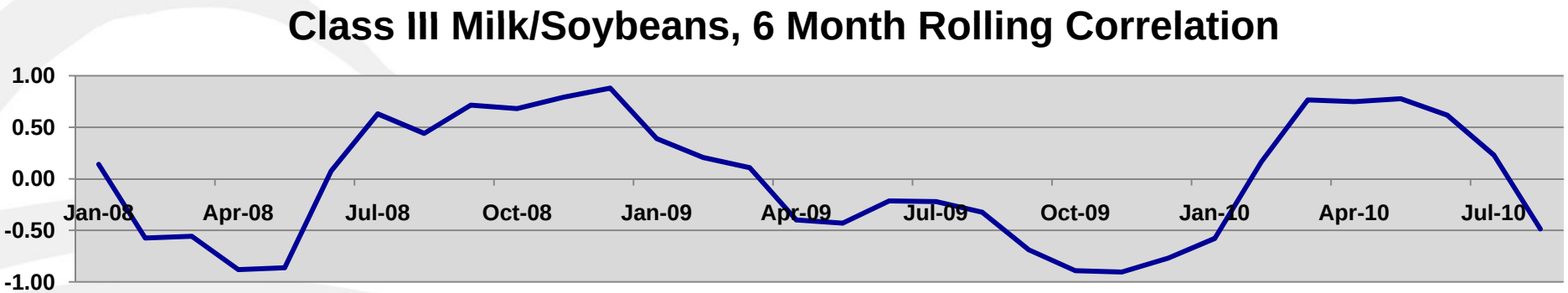
Dairy Industry Commodity Risk

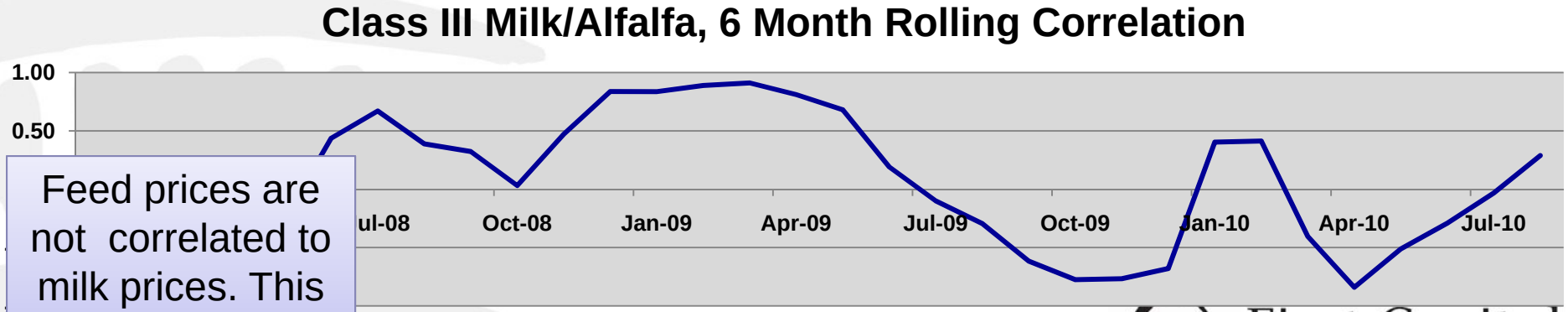


First Capitol
Risk Management

Dairy Industry Commodity Correlation



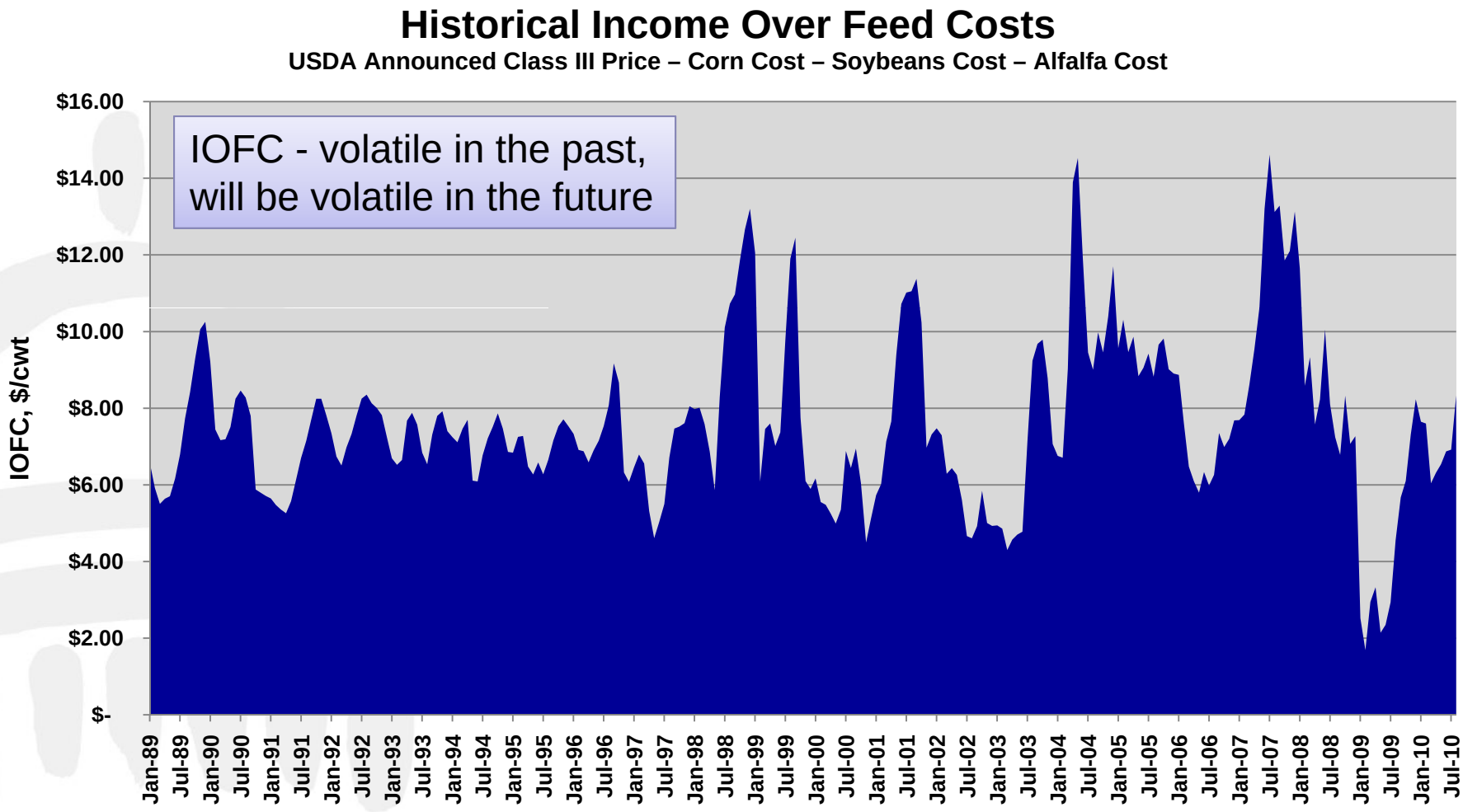




Feed prices are not correlated to milk prices. This creates risk.

First Capitol
Risk Management

Dairy Industry Margins



First Capitol
Risk Management

Market Outlook

- The only commodity forecast we can give with certainty is that volatility will continue.
- This drives all dairy producers to a series of decision points…

First Capitol
Risk Management

Agenda

- About Us
- Margin Management
  - **Challenges**
  - **Decisions**
  - **Steps**
- Moving Forward

First Capitol
Risk Management

Decision #1: To Hedge or Not to Hedge…

Moving Forward Hedged

Objective:
Smooth cash flows
Lock in profits
Mitigate risks

Requirements:
Understanding
Planning
Consistency in Execution

Benefits:
Financial Stability
Peace of Mind
Long Term Planning

Moving Forward Un-hedged

Objective:
Ride Out the Market Cycles

Requirements:
Liquidity
Luck

Benefits?
Lower Up-Front Cost
No Need to Change

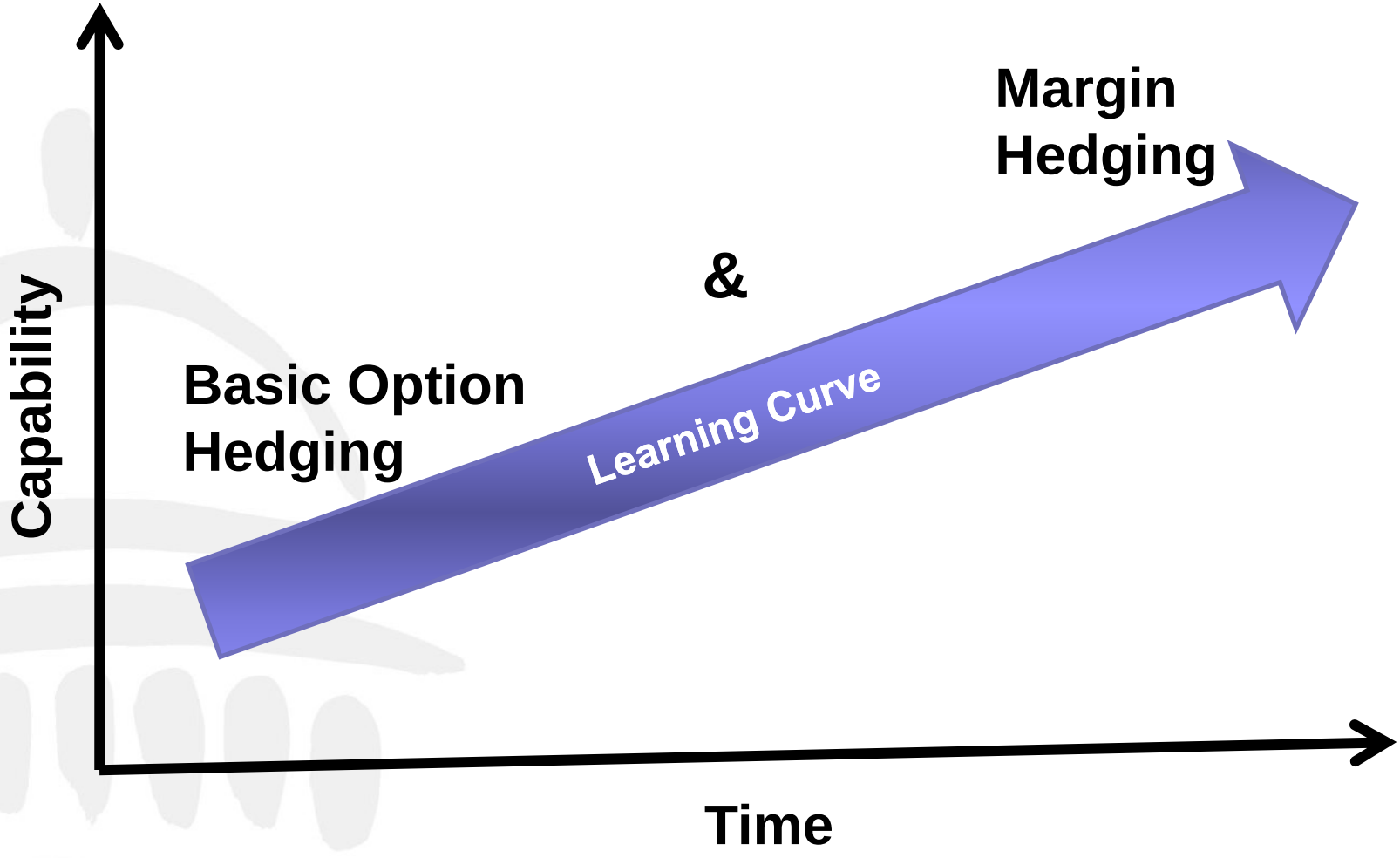
First Capitol
Risk Management

Decision #2: How Should I Hedge?

- Options Only
- Cash Market Tools Only
- Futures Only
- Non-marginable Positions Only
- Marginable Positions
- Milk Only
- All Cash, Futures and Options Positions for Milk and Feed
- ***Structured Margin Management Program***

First Capitol
Risk Management

What do We Advocate?



First Capitol
Risk Management

Margin Hedging

- **Definition**
  - ***Matched hedge positions*** that simultaneously protect input and output commodity prices
- **Benefits**
  - Allows for a ***focus on profitability*** rather than individual commodity price direction
  - Eliminates the need to be right on timing, direction and price level on each individual leg of the profit margin spread
- **Requirements**
  - Accurate Operational Model
  - Accurate Cost Model
  - Cash & Futures Trades Captured
  - Mark-to-Market Forward Curve
  - Hedging Policy

First Capitol provides these services as an 'on-staff' risk manager

First Capitol
Risk Management

Agenda

- About Us
- Margin Management
  - **Challenges**
  - **Decisions**
  - **Steps**
- Moving Forward

First Capitol
Risk Management

Implementing a Margin Hedging Program

- **Three Practical Steps**

1. Understanding
2. Planning
3. Execution

First Capitol
Risk Management

1. Understanding

- **Tools** – what tools are available to mitigate my risk?
- **Philosophy** – what should my expectations be in mitigating my risk?
- **Strategy** – what specific approach should I use to mitigate my risk?

First Capitol
Risk Management

Risk Management Philosophy

Commodity price direction cannot be consistently predicted.

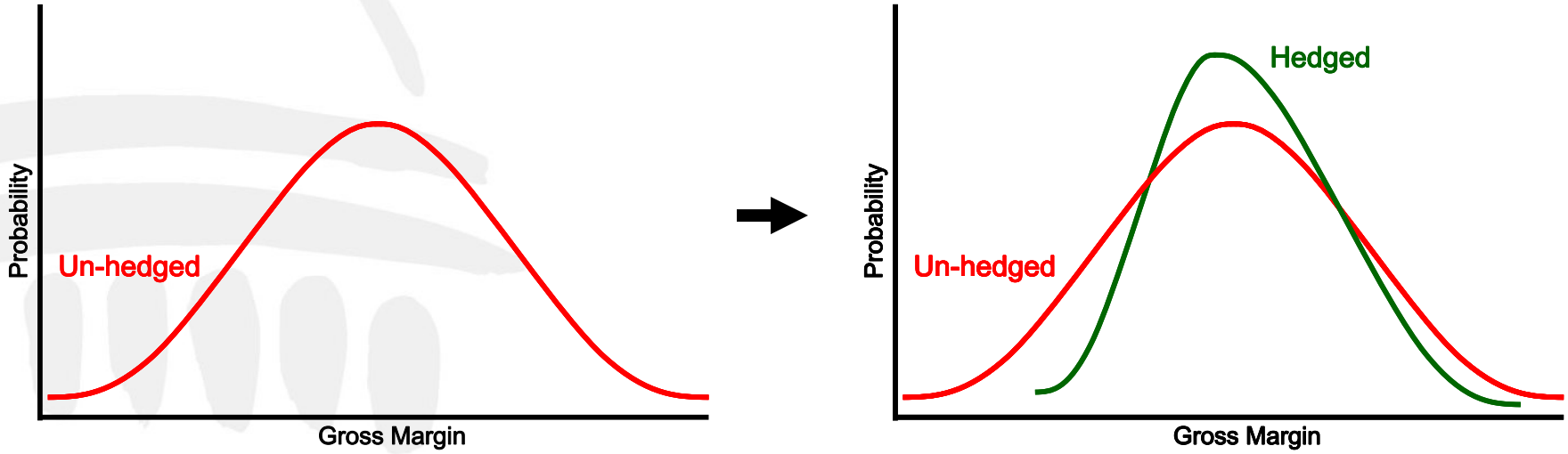
With volatility comes risk and opportunity.

A systematic and structured risk management approach is needed.

First Capitol
Risk Management

Risk Management Objectives

- To reduce earnings variability
- To lock in margins with matched positions
- To take advantage of attractive forward prices
- To prevent losses due to price volatility
- To re-shape the earnings distribution



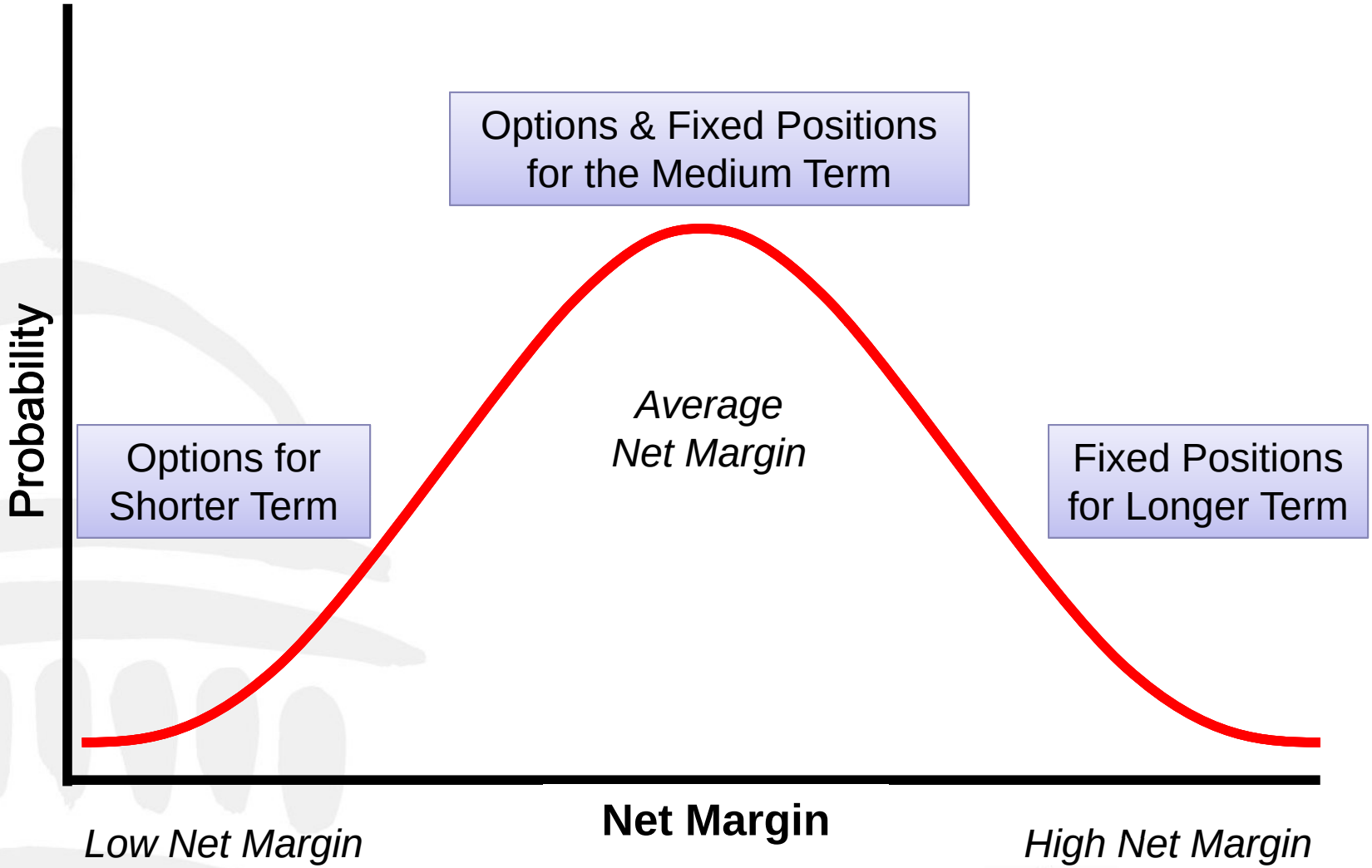
First Capitol
Risk Management

Risk Management Strategy

- **Margin Hedging**
  - ***Option Coverage*** – buy time with a basic option approach while waiting for favorable margins
  - ***Matched Positions*** – inputs and outputs are hedged with matched positions
  - ***Scale into Positions*** – lock in margin cautiously at average margins and lock in margin aggressively at high margins
  - ***Targets and Objectives*** – historical data, trends and financial goals

First Capitol
Risk Management

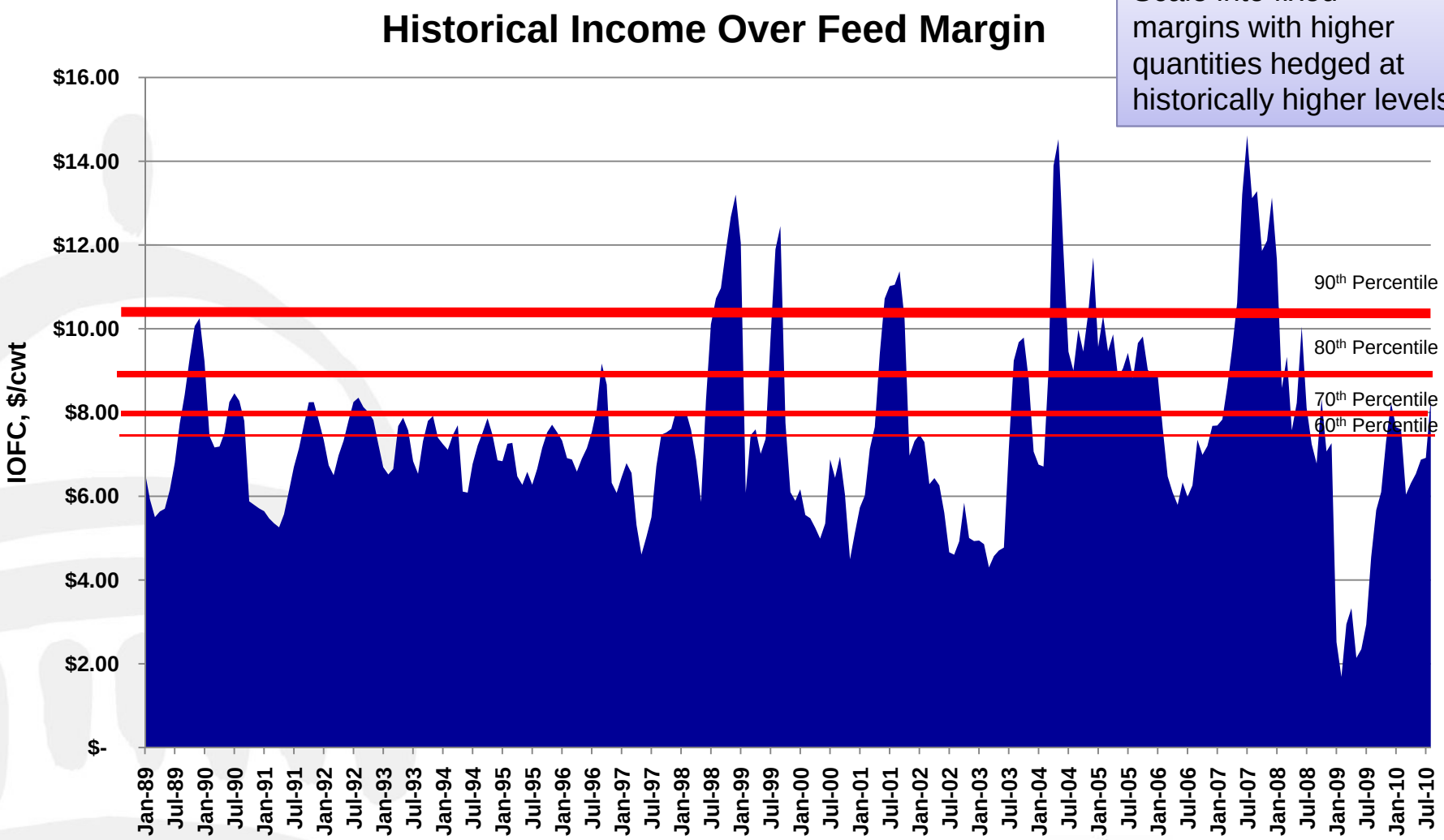
Risk Management Strategy



First Capitol
Risk Management

Margin Hedging Strategy

Scale into fixed margins with higher quantities hedged at historically higher levels



First Capitol
Risk Management

2. Planning

- **Create a Policy** – what is my game plan? how do I stay consistent?
- **Gather Data & Build Your Model** – can I measure my risk?
- **Obtain Financing** – can I fund these hedge positions?

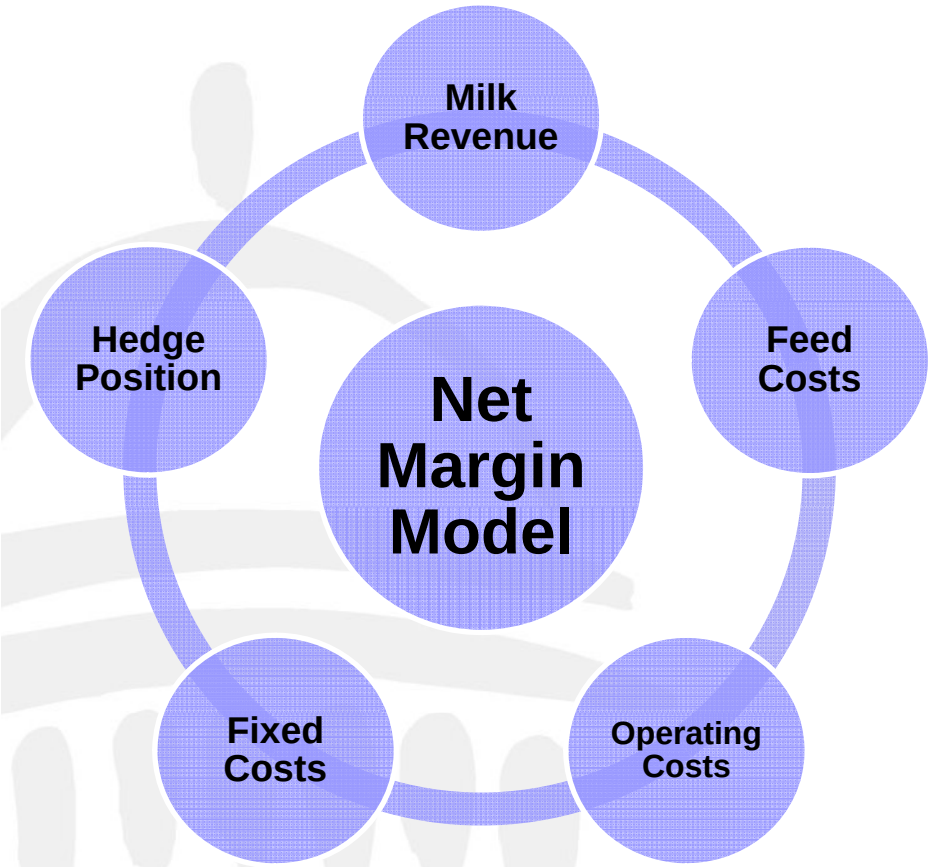
First Capitol
Risk Management

Create a Policy

- **Written Document Facilitates Decisiveness**
  - Authorized Tools
  - Position Limits
  - Price Targets
  - Margin Targets
  - Premium Budgets
  - Financing Limits
  - Stress Tests
  - Authorized Traders
  - Oversight & Reporting

First Capitol
Risk Management

Gather Data & Build Your Model



- **Forward Curve Model Objectives**
  - **Capture All Data**
    - Revenue
    - Feed
    - Operational
    - Financials
    - Hedges
  - **Mark-to-Market in Real Time**
  - **Provide Actionable Reports**
    - Exposure
    - Price
    - Position
    - P&L

First Capitol
Risk Management

Obtain Financing

- Understand financing obligations of your hedging program
- Obtain credit facilities where applicable
- Evaluate cash market tools and other alternatives

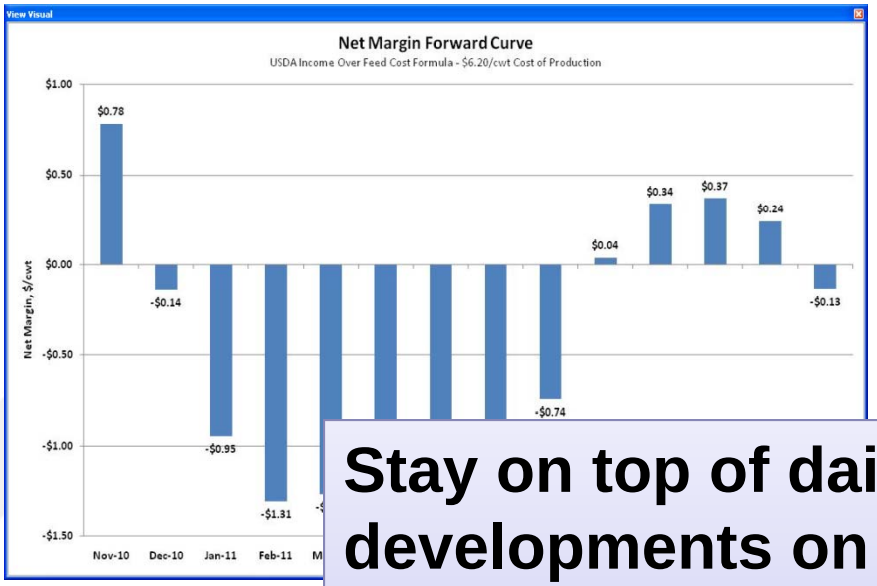
First Capitol
Risk Management

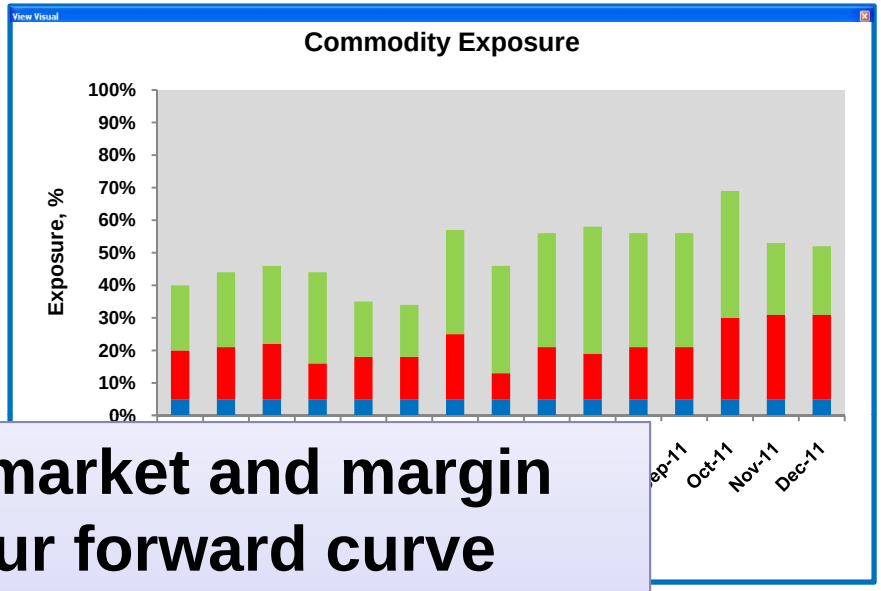
3. Execution

- **Monitoring** – what do I need to be looking at on a daily basis?
- **Hedge Execution** – how do I pull the trigger?
- **Tracking & Refining** – how did I perform? how do I continuously improve?

First Capitol
Risk Management

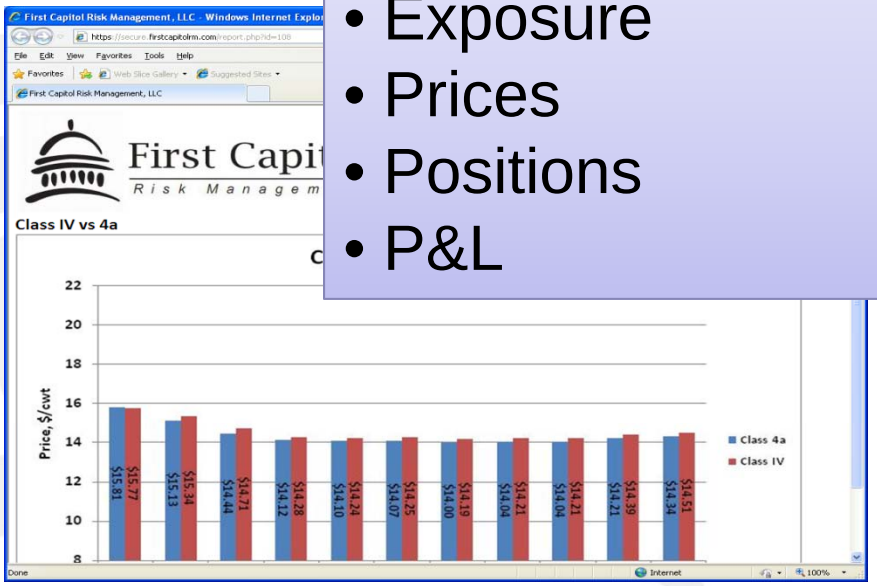
Monitoring





Stay on top of daily market and margin developments on your forward curve

- Exposure
- Prices
- Positions
- P&L



Risk Management

Hedge Execution

- **Analyze Hedge Alternatives**
  - Policy constraints
  - Financial constraints
  - Fundamentals
  - Risk/Reward tradeoffs
- **Execute Hedge Transactions**
  - Cash
  - Futures
  - Options

First Capitol
Risk Management

Tracking & Refining the Program

- **Monthly** – Close-out each hedge period to evaluate the performance
  - financial and physical hedges
  - Operating and cost assumptions
- **Annually** – Review strategy and policy

First Capitol
Risk Management

Agenda

- About Us
- Margin Management
  - **Challenges**
  - **Decisions**
  - **Steps**
- **Moving Forward**

First Capitol
Risk Management

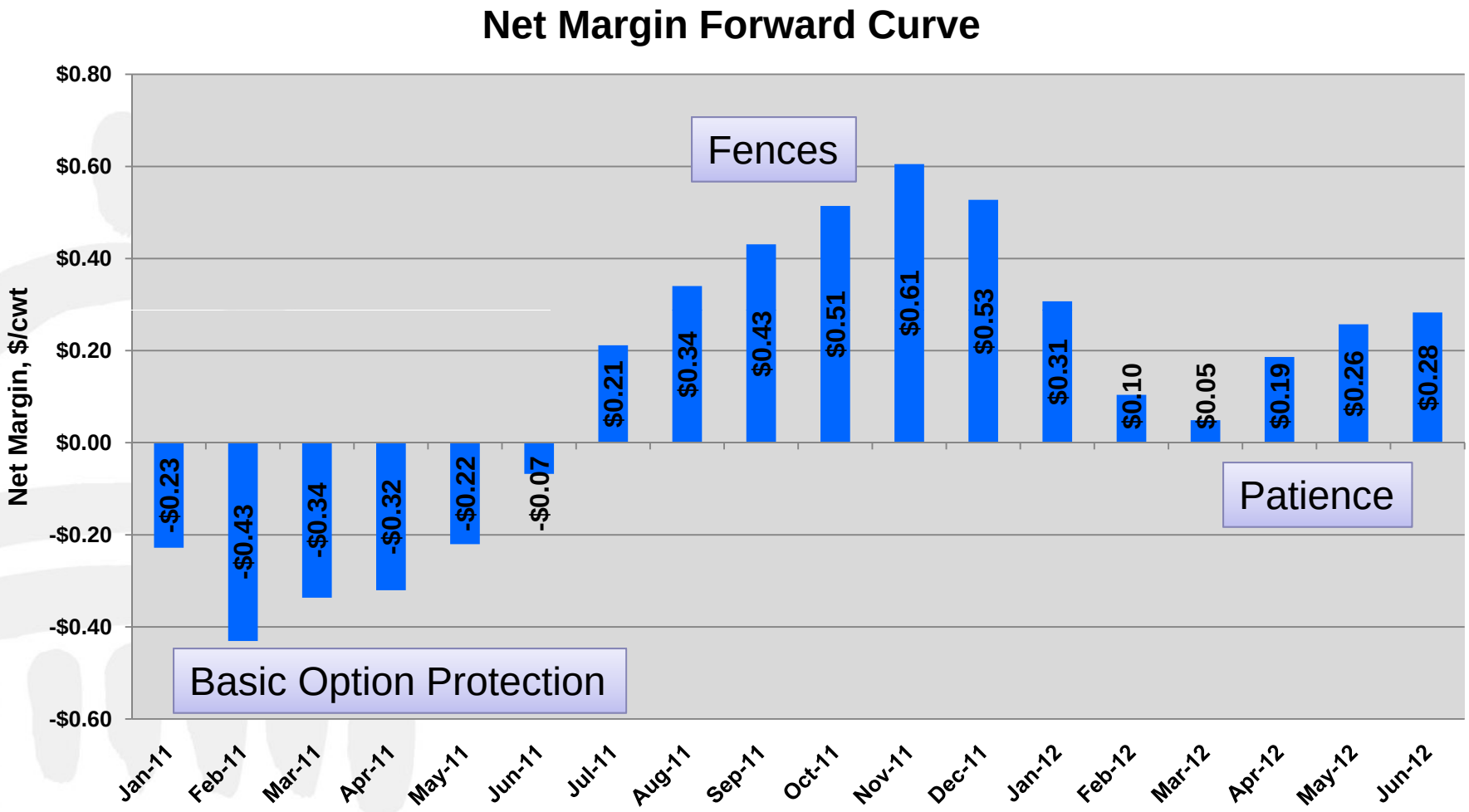
Margin Hedging Summary

Benefits

- Focused on profitability rather than individual commodity price direction
- Eliminates the need to be right on timing, direction and price level on all legs of the spread
- Reduces the volatility of cash flows
- Allows producers to focus on production rather than prediction
- Allows for steady operation during industry downturns
- Reduces hidden costs driven by financial stress

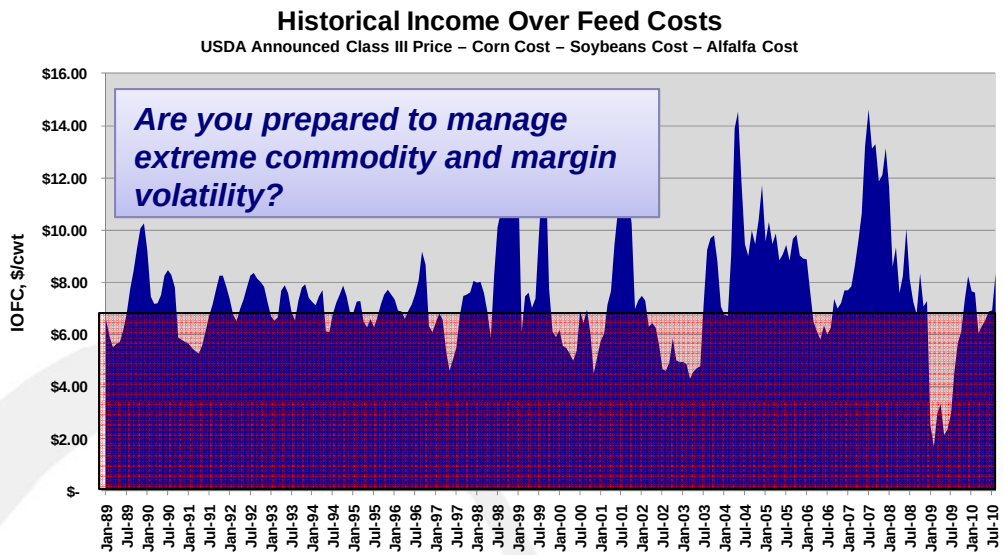
First Capitol
Risk Management

Forward Curve Today



First Capitol
Risk Management

First Capitol Dairy Margin Management

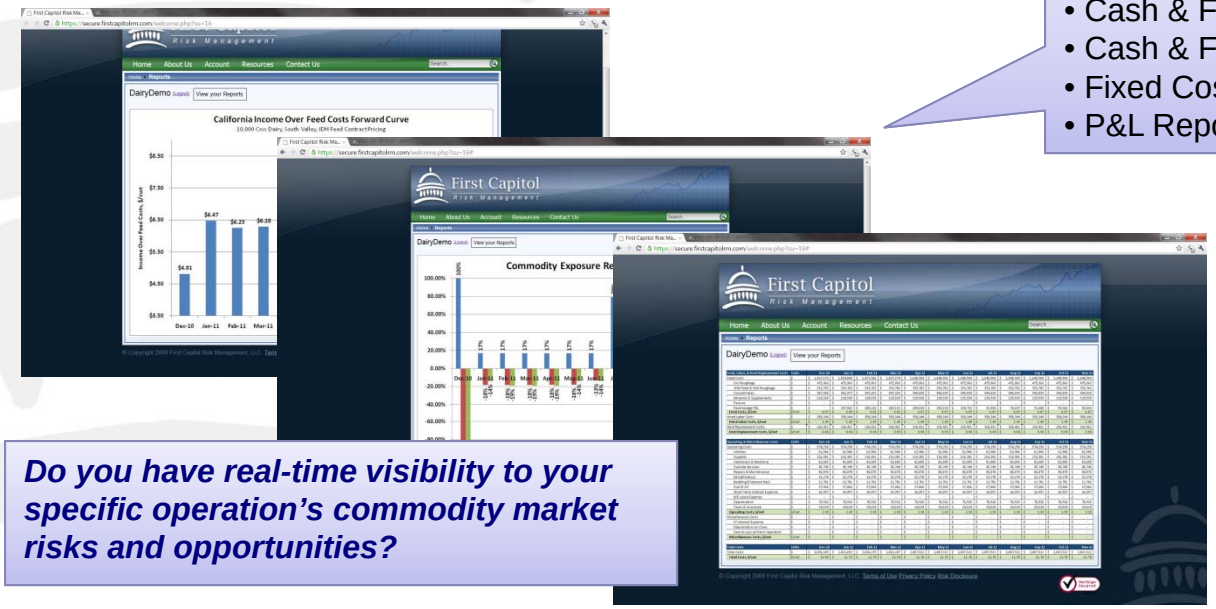


Are you prepared to manage extreme commodity and margin volatility?

Dairy Margins are Volatile.
First Capitol Provides the Services and Tools Needed to Succeed.

'On Staff' Risk Manager Service
- Education & Training
- Strategy & Policy Development
- Forward Curve Modeling
- Hedge Recommendations
- Hedge Execution
- Position Tracking & Reporting

Daily Marked-to-Market Web Based Reports
- Exposure & Risk Reports
- Cash & Futures Price Reports
- Cash & Futures Position Reports
- Fixed Cost & Operating Model Reports
- P&L Reports & Net Margin Forward Curve



Do you have real-time visibility to your specific operation's commodity market risks and opportunities?

First Capitol
Risk Management

11380 Dandar St, Galena IL 61036
Phone: 800-884-8290
Web: www.firstcapitolrm.com

First Capitol Risk Management

Contact Information

Will Babler
wbabler@firstcapitolrm.com
815-777-1129
www.firstcapitolrm.com

Risk Disclosure: First Capitol Risk Management, LLC uses sources that they believe to be reliable, but they cannot warrant the accuracy of any of the data included in this report. Futures and Options trading provided through First Capitol Group a registered Futures Commission Merchant. Trading in commodities, futures, options or other derivatives, and OTC products entails significant risks which must be understood prior to trading. References to and discussions of OTC products are made solely on behalf of First Capitol Risk Management, LLC. Neither the information, nor any opinion expressed, constitutes a solicitation to buy or sell futures or options on futures contracts, or OTC products. Past performance is not indicative of future results. Reproduction without authorization is forbidden. All rights reserved.

First Capitol
Risk Management