

First Capitol Risk Management

Dairy Margin Management

HEDGING STRATEGIES FOR CALIFORNIA DAIRIES

Modesto December 6, 2010

Tulare December 7, 2010



First Capitol

R i s k M a n a g e m e n t

Agenda

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

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

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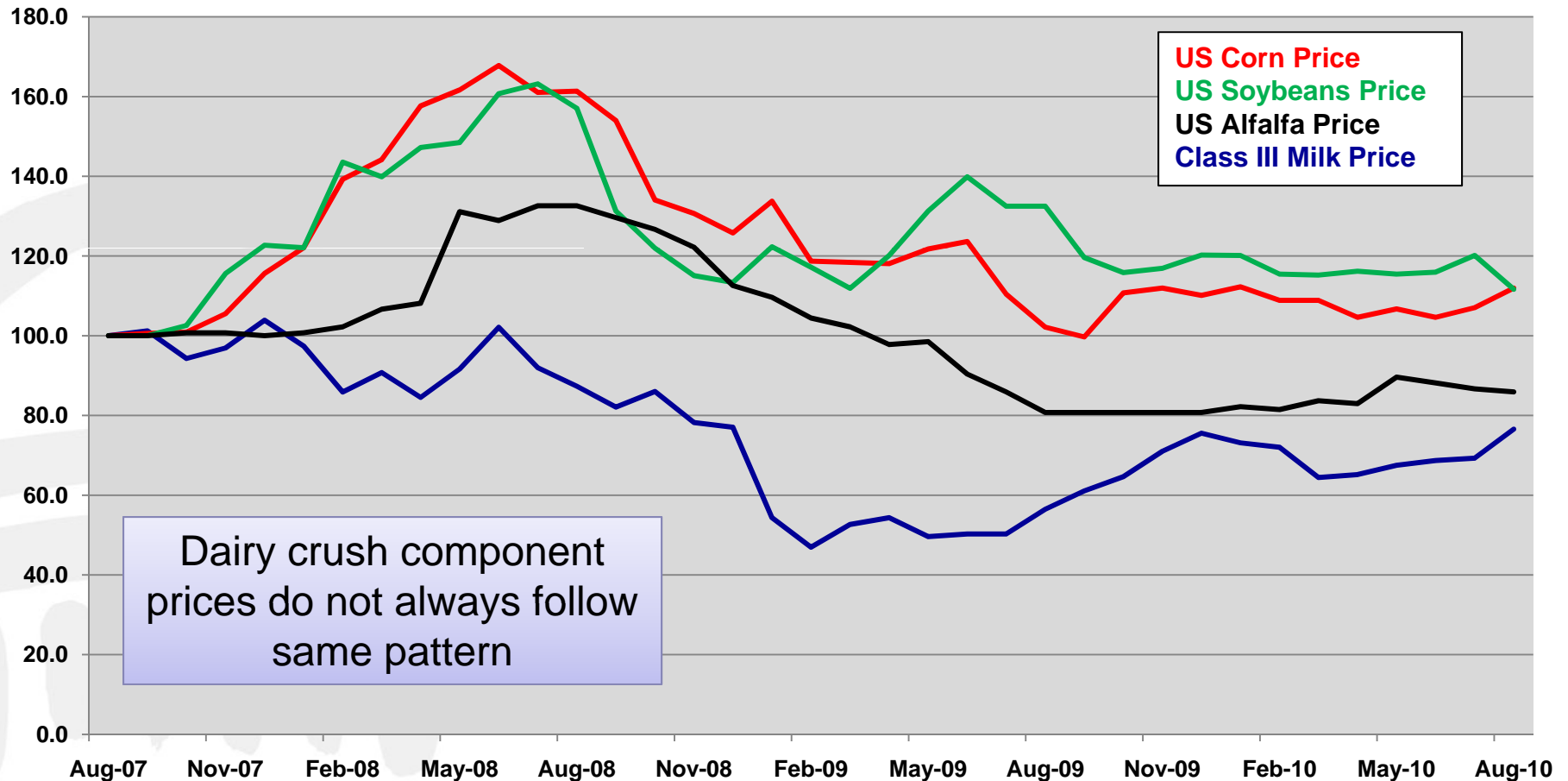


Challenges

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

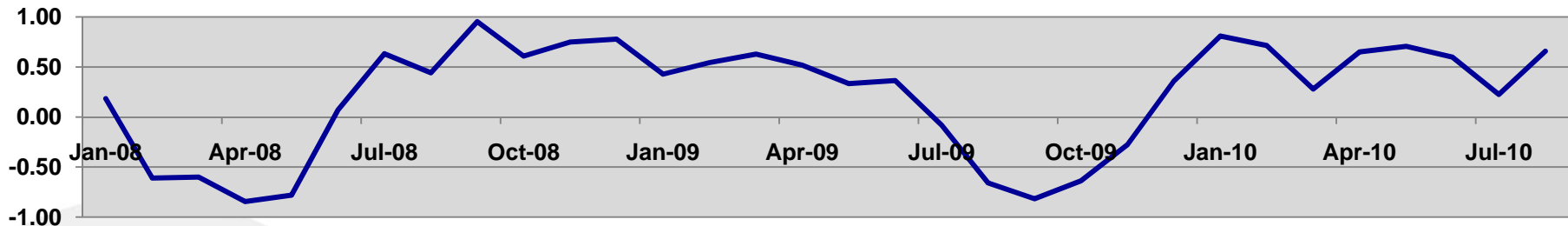
Dairy Industry Commodity Risk

Corn/Soybeans/Alfalfa/Class III Milk Index

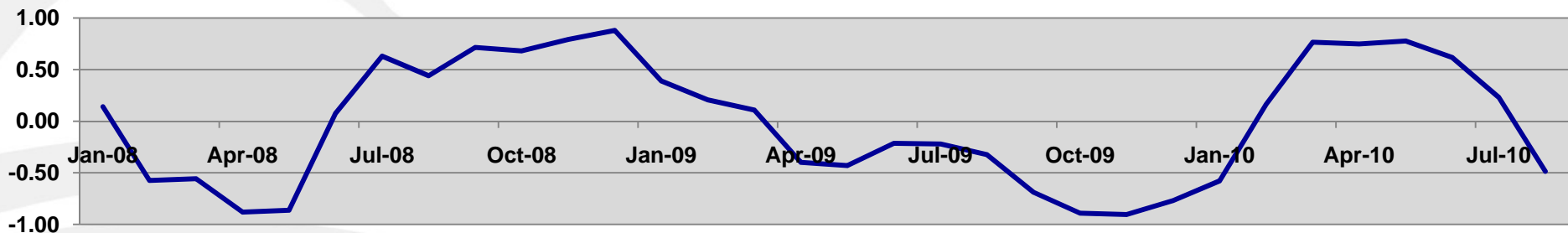


Dairy Industry Commodity Correlation

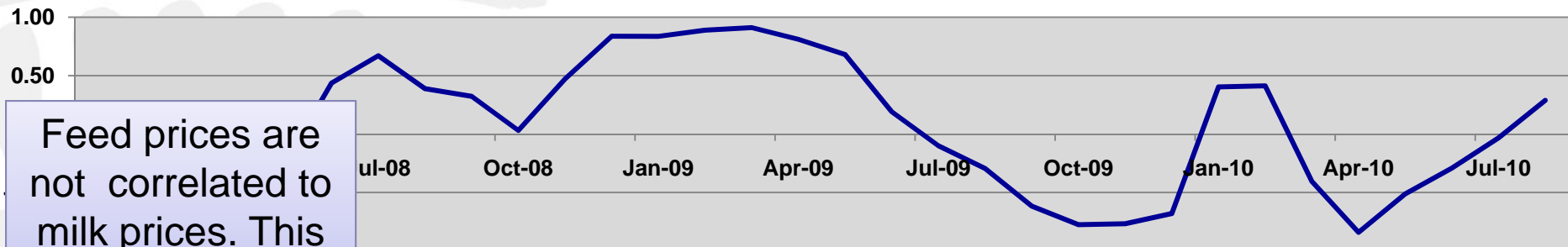
Class III Milk/Corn, 6 Month Rolling Correlation



Class III Milk/Soybeans, 6 Month Rolling Correlation



Class III Milk/Alfalfa, 6 Month Rolling Correlation

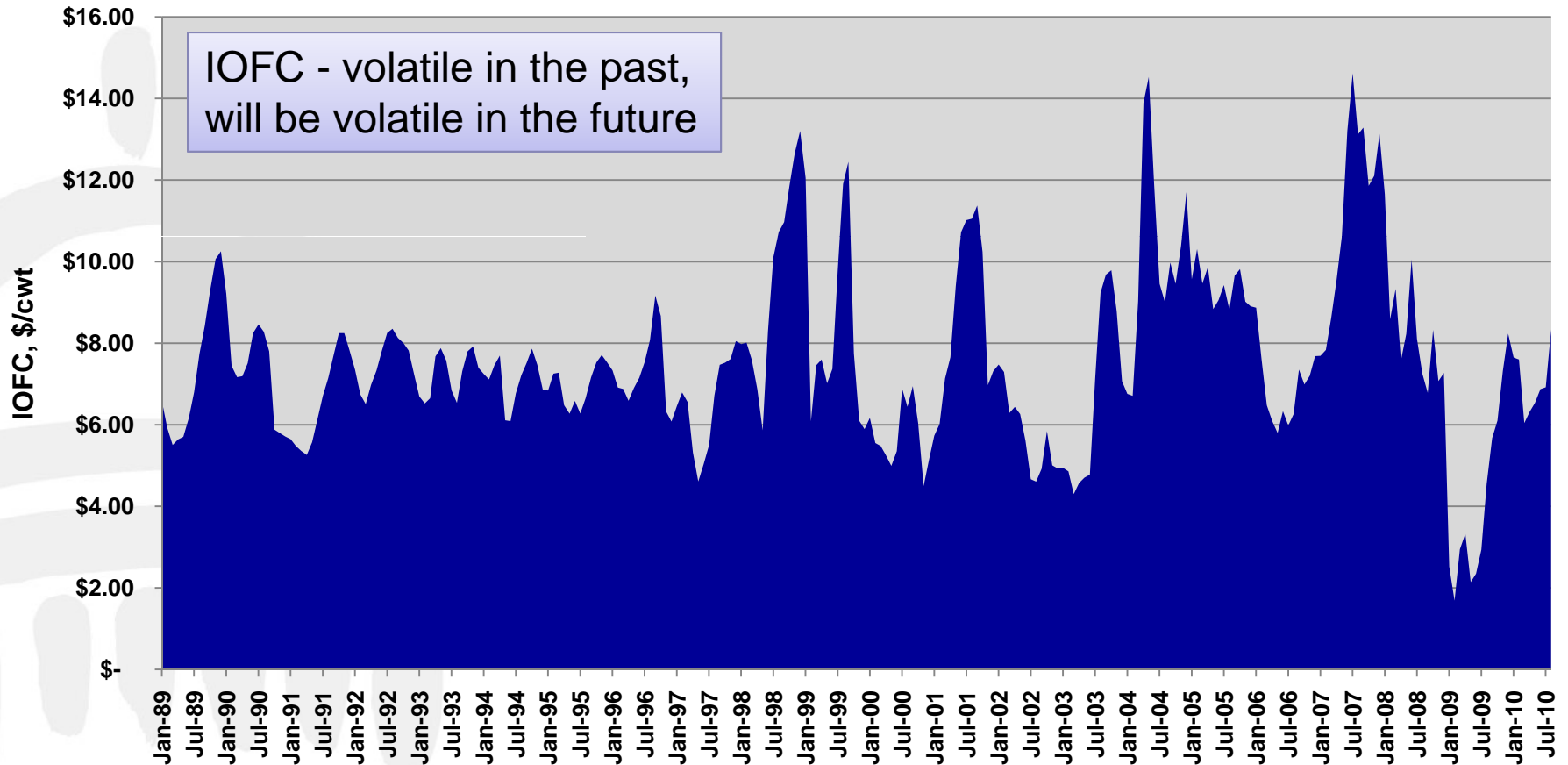


Feed prices are not correlated to milk prices. This creates risk.

Dairy Industry Margins

Historical Income Over Feed Costs

USDA Announced Class III Price – Corn Cost – Soybeans Cost – Alfalfa Cost



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...



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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



Decision #2: How Should I Hedge?

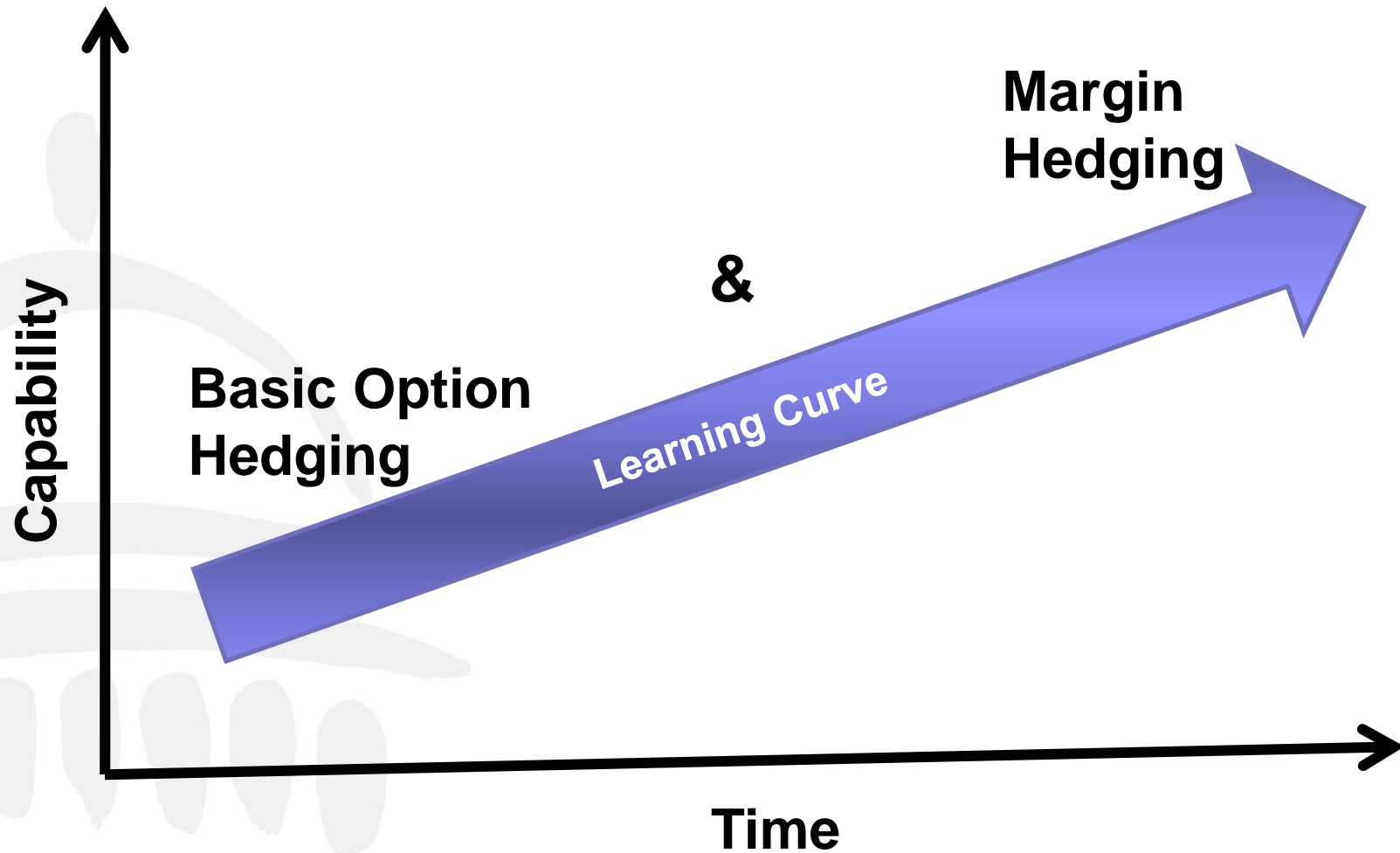
Hedging Experience Spectrum

- 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***



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Risk Management

What do We Advocate?



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



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Implementing a Margin Hedging Program

■ Three Practical Steps

1. Understanding

2. Planning

3. Execution

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?



Risk Management Philosophy

Commodity price direction cannot be consistently predicted.

With volatility comes risk and opportunity.

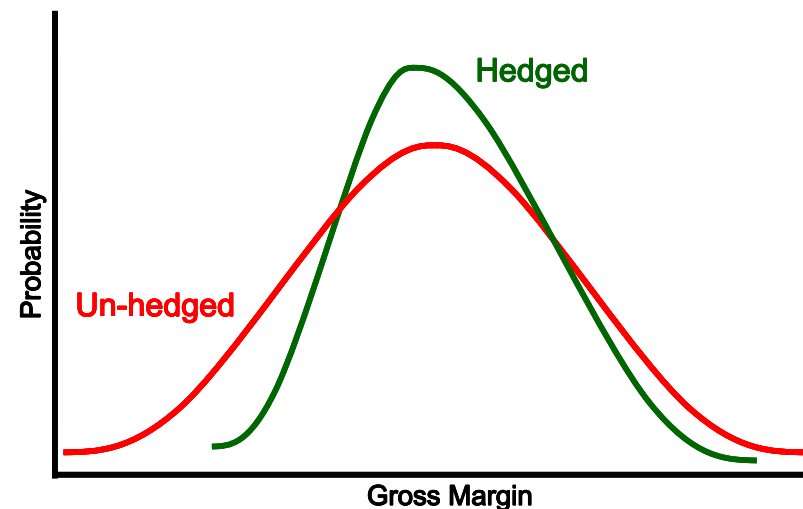
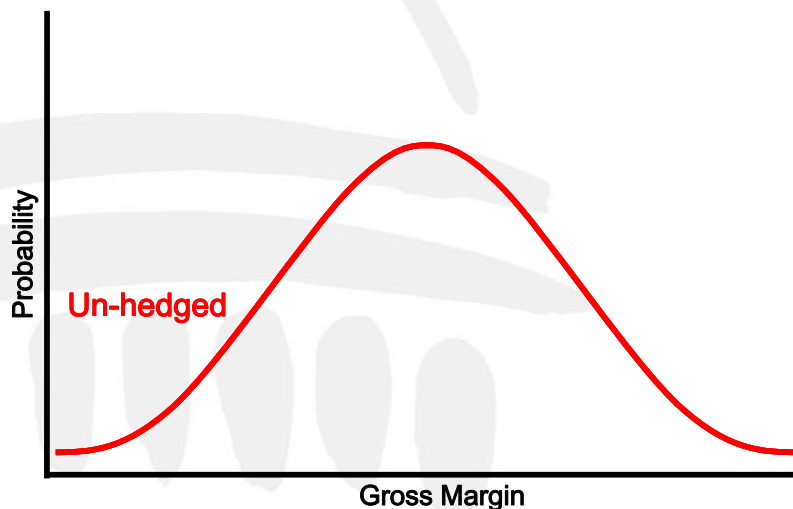
A systematic and structured risk management approach is needed.



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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

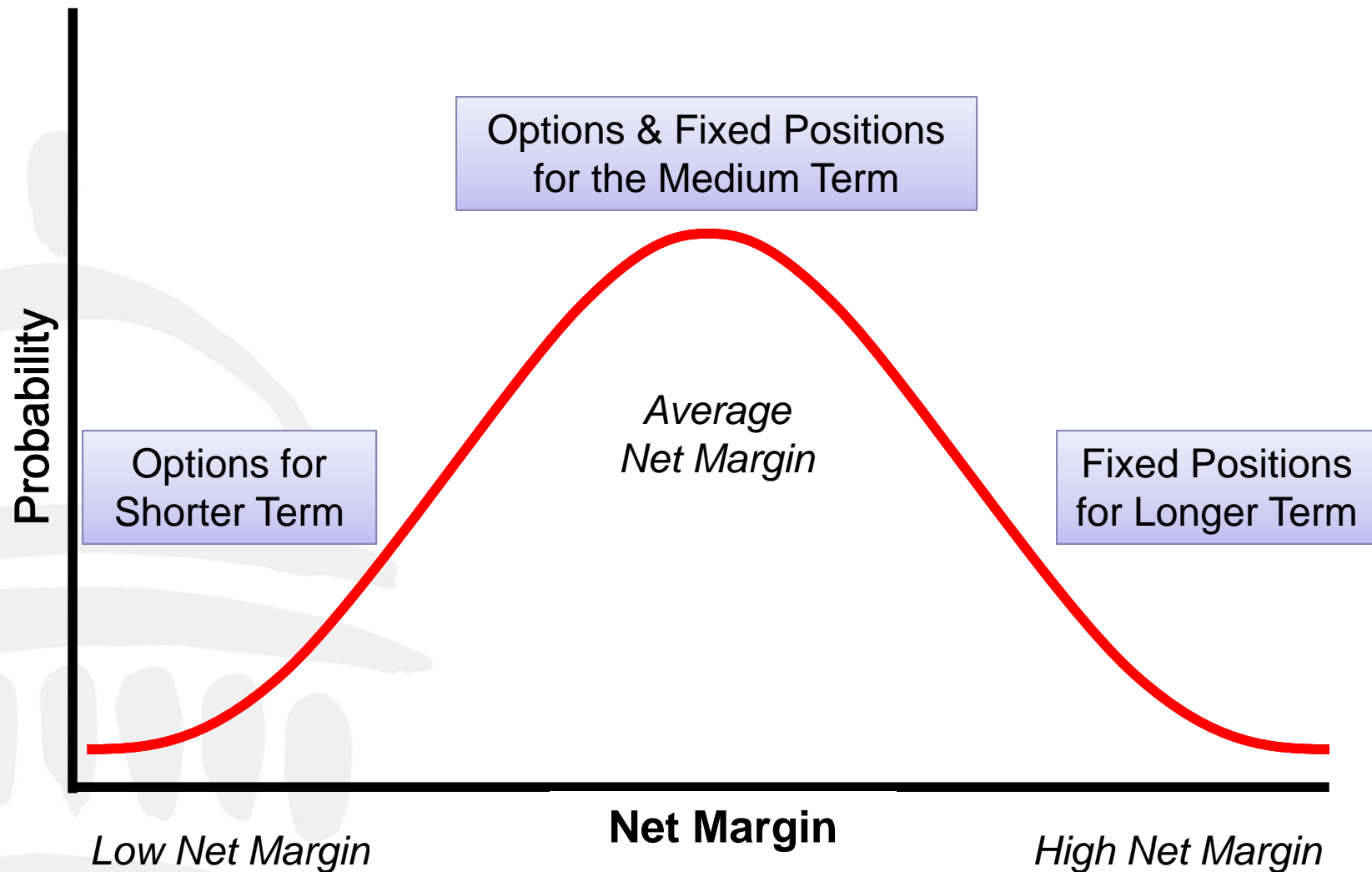


Risk Management Strategy

■ 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

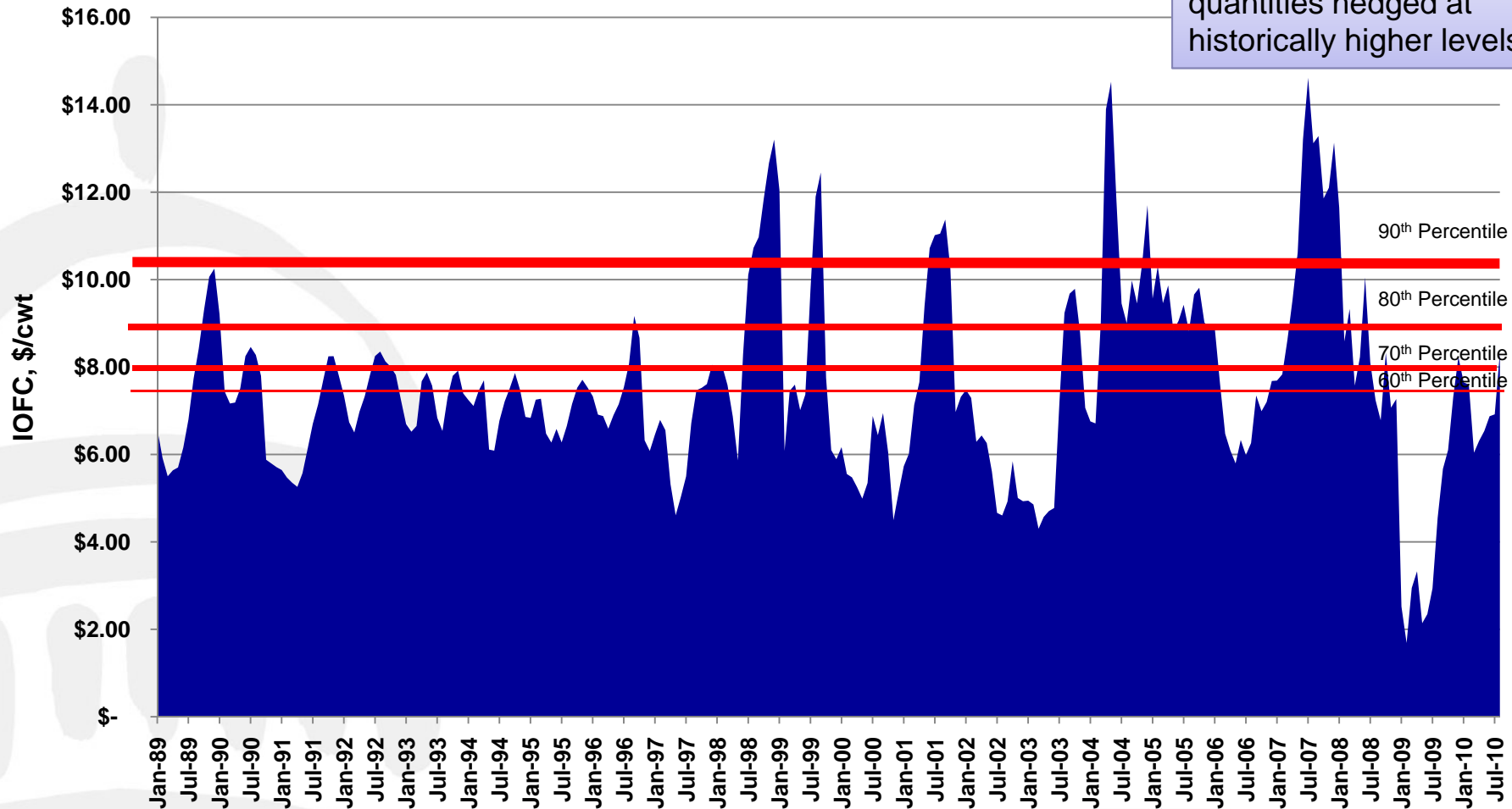
Risk Management Strategy



Margin Hedging Strategy

Historical Income Over Feed Margin

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



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?

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

Gather Data & Build Your Model

■ Forward Curve Model Objectives

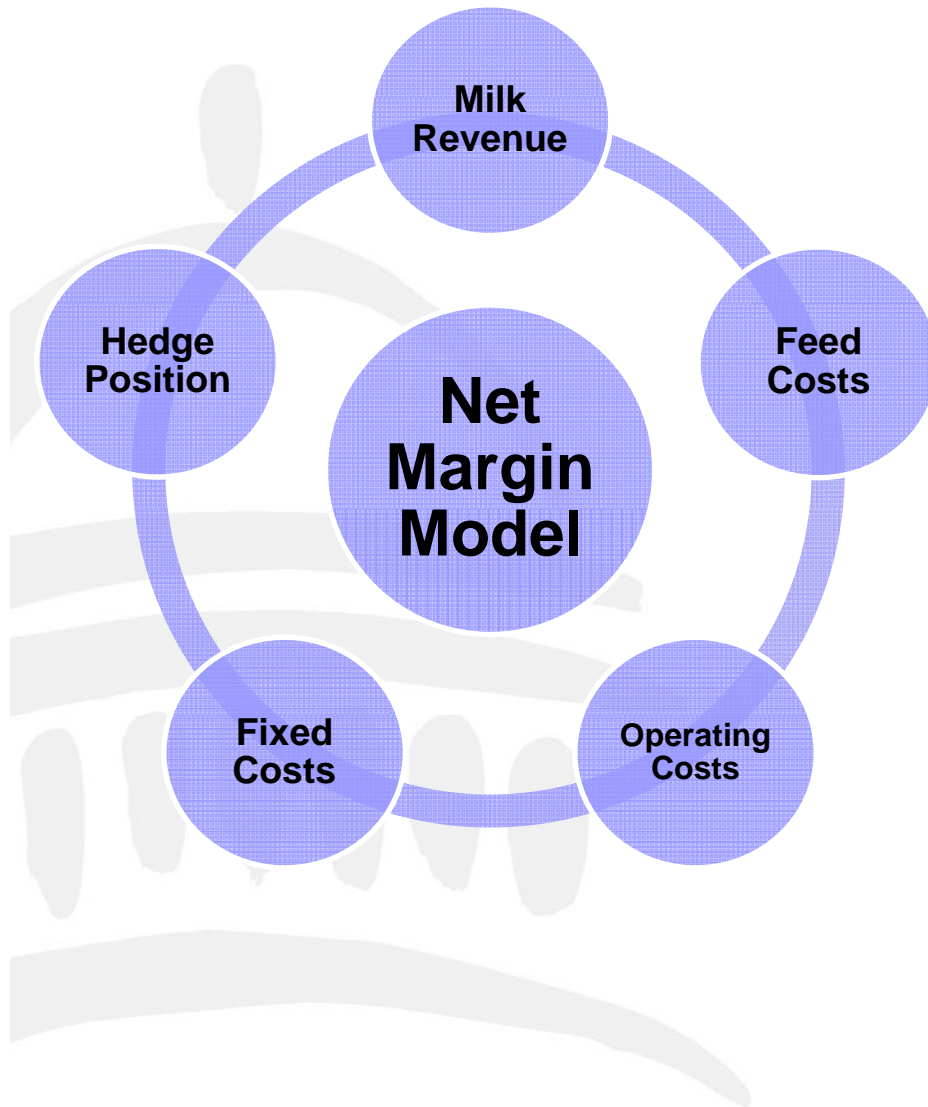
□ Capture All Data

- Revenue
- Feed
- Operational
- Financials
- Hedges

□ Mark-to-Market in Real Time

□ Provide Actionable Reports

- Exposure
- Price
- Position
- P&L



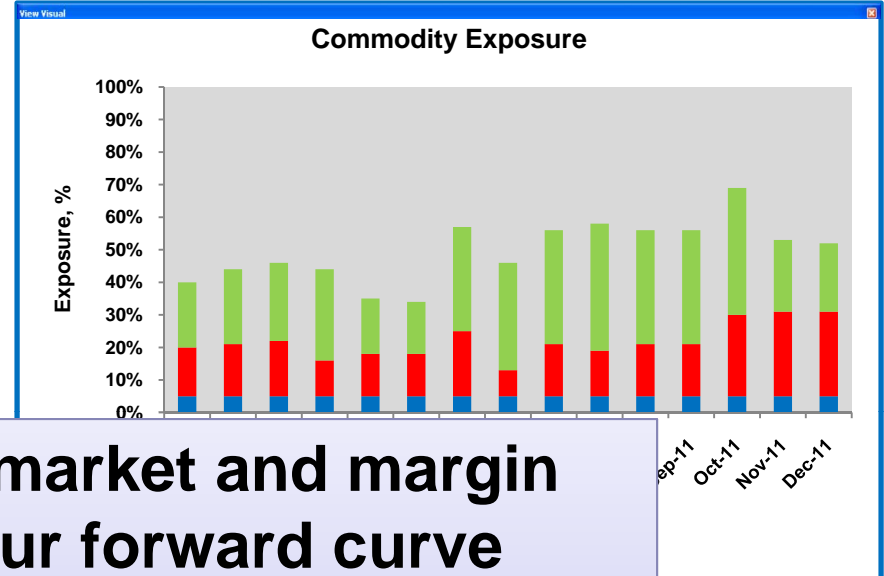
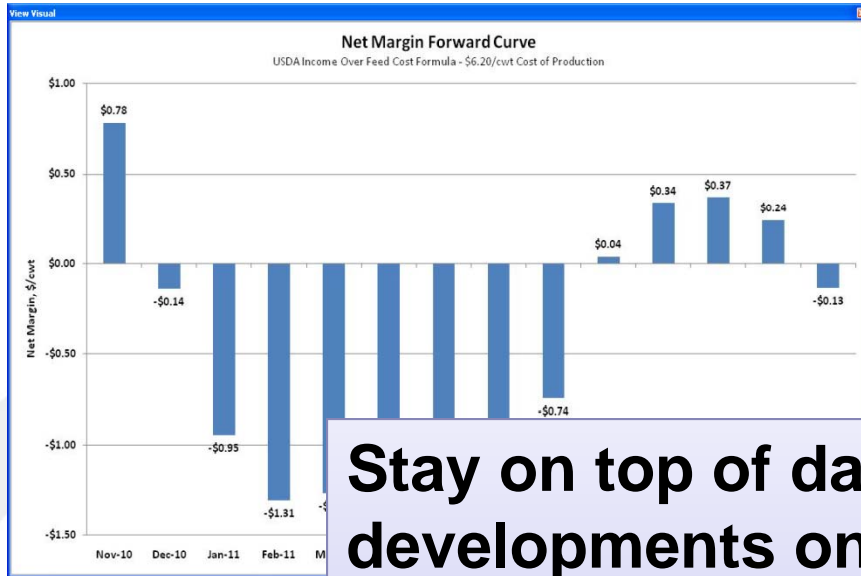
Obtain Financing

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

3. Execution

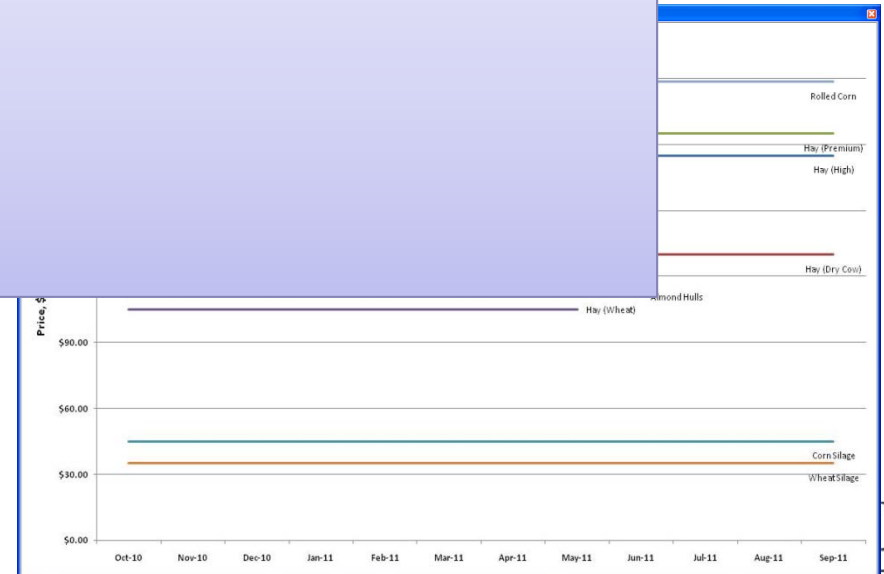
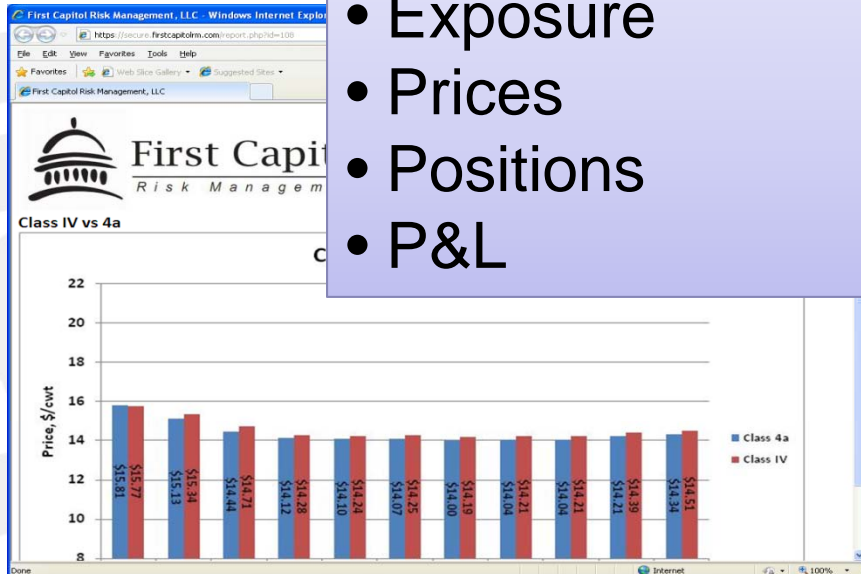
- **Monitoring** – what do I need to be looking at on a daily basis?
- **Hedge Execution** – how do I pull the trigger?
- **Tracking & Refining** – how did I perform?
how do I continuously improve?

Monitoring



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

- Exposure
- Prices
- Positions
- P&L



Hedge Execution

■ Analyze Hedge Alternatives

- Policy constraints
- Financial constraints
- Fundamentals
- Risk/Reward tradeoffs

■ Execute Hedge Transactions

- Cash
- Futures
- Options

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

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Margin Hedging Summary

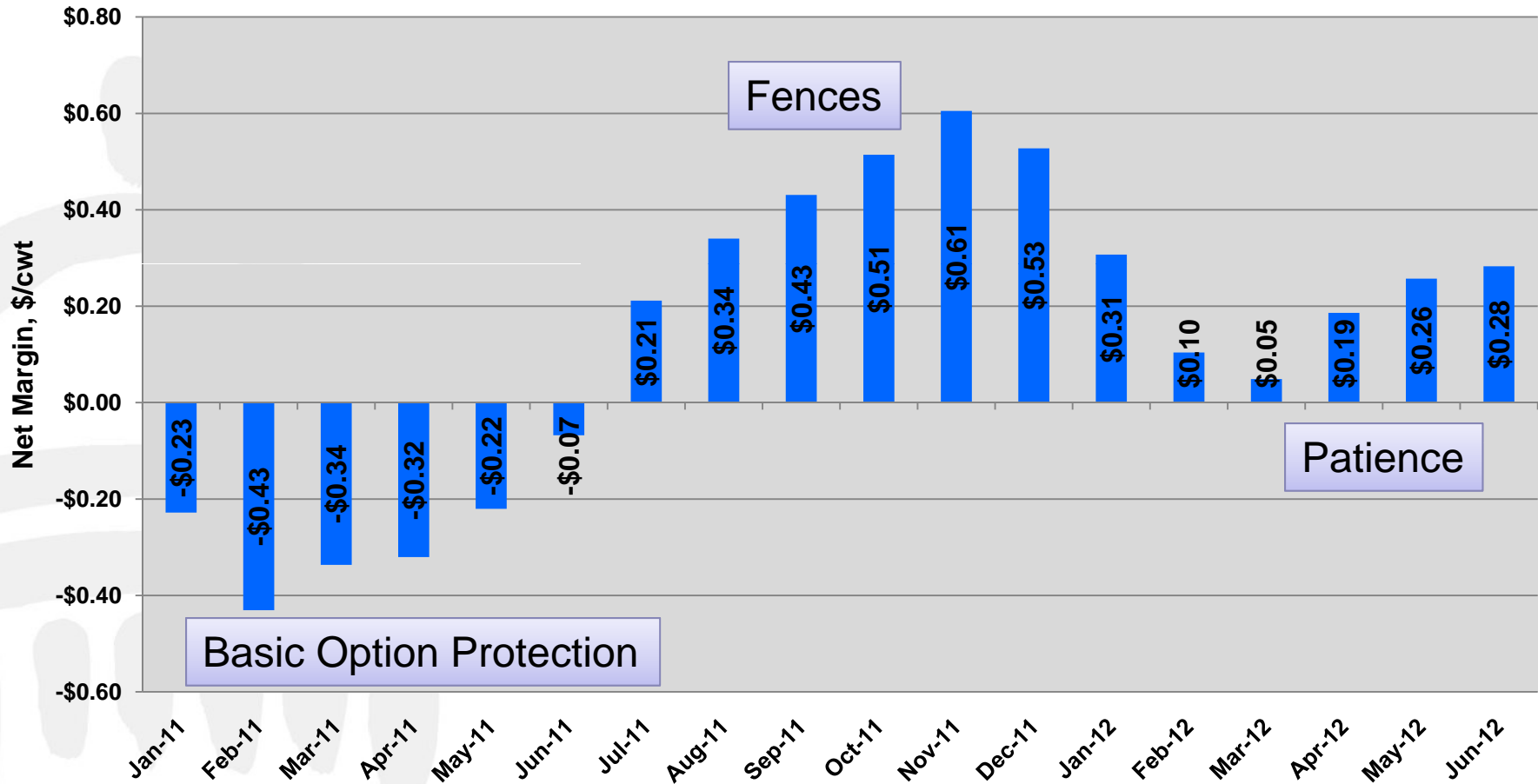
Benefits

- 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



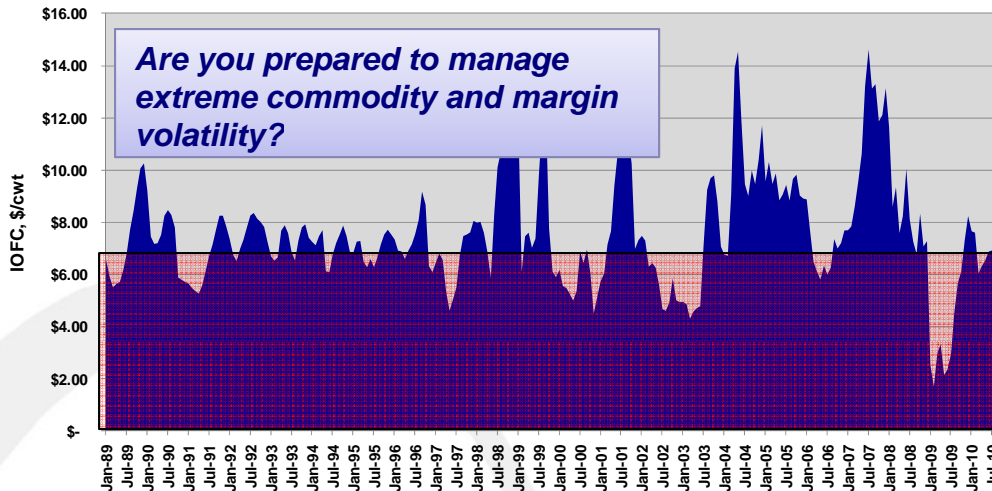
Forward Curve Today

Net Margin Forward Curve



First Capitol Dairy Margin Management

Historical Income Over Feed Costs
 USDA Announced Class III Price – Corn Cost – Soybeans Cost – Alfalfa Cost



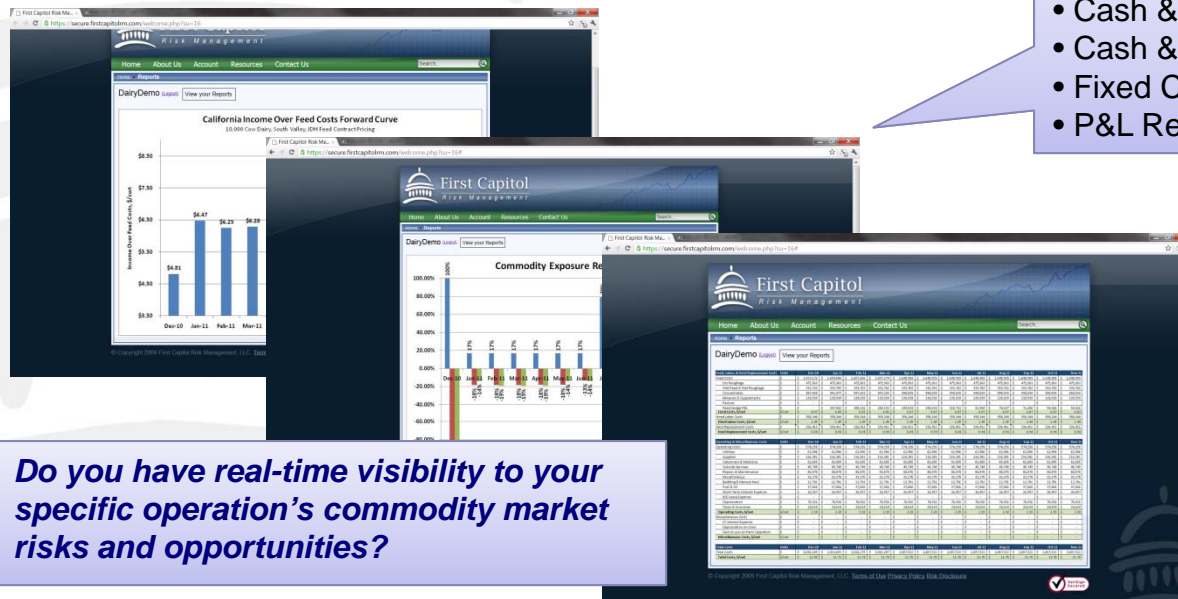
Dairy Margins are Volatile. First Capitol Provides the Services and Tools Needed to Succeed.

'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

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First Capitol Risk Management

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