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Dean Foods Co faces increasing headwinds

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Traditional dairy companies in the United States are currently facing headwinds, due to the rising cost of production and changing consumer preferences for milk alternatives. The US dairy industry is also facing additional challenges as a result of the trade dispute with China, US' third largest dairy importer. The negative effects caused by the tariff are expected to persist even after the tariffs are removed, as companies would have to work towards regaining foreign market shares. US' largest dairy company, Dean Foods Co, has seen its market capitalization tumbled by approximately 59.1% over the past year, as the company also battles soft volumes, increased competition and input cost inflation. At the same time, the NUS-CRI 1-year PD rose from 43.34bps to 200.80bps in the same period.

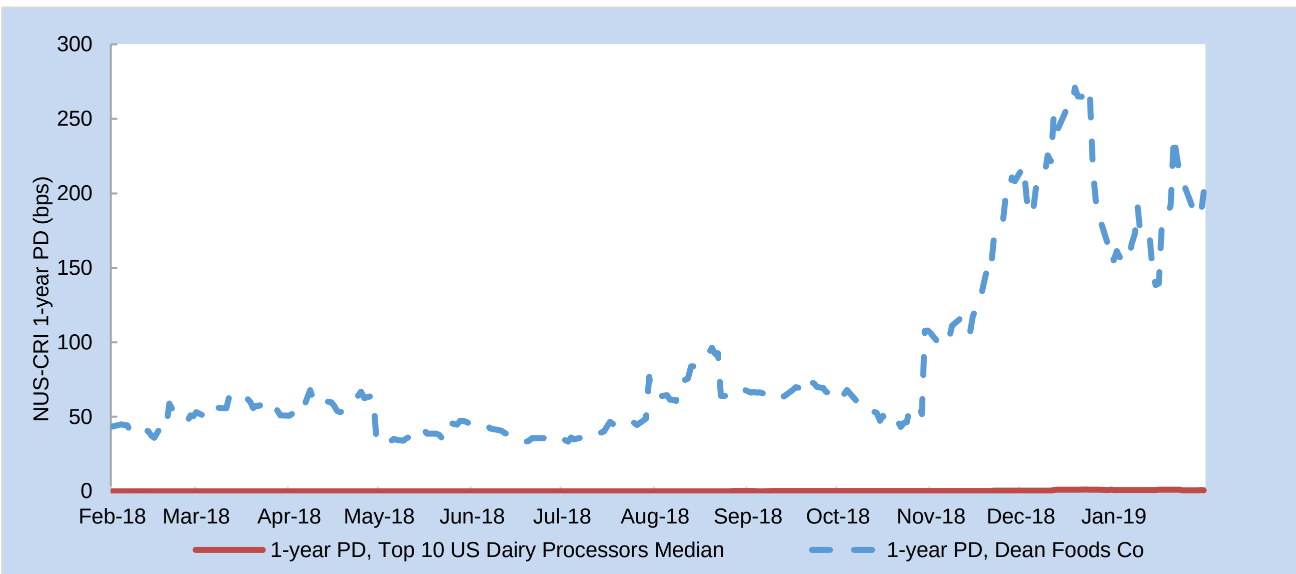

Figure 1: NUS-CRI 1-year PD for Dean Foods Co and NUS-CRI Aggregate 1-year PD of top 10 publicly-listed US dairy processors. *Source: NUS-CRI.*

Since last year, the price competition between grocers such as Kroger and Walmart have intensified as they seek to attract more consumers by slashing prices, including the prices of their milk products. As Dean Foods' did not follow suit, its milk brands have become relatively more expensive by at least 40%, thus impacting its sales performance. In addition, Walmart, which used to be Dean Foods' largest customer, ended its contract with Dean Foods and opened its own milk processing facility in Indiana last year. The loss of contract is estimated to decrease Dean Foods' volume for its private label milk production by 100-110 million gallons annually. According to Moody's, this loss represents 4.3% of Dean Foods' 2017 total volume across all products.

On top of the intense pricing competition and the loss of a major contract, Dean Foods is also battling changing consumer preference. According to Mintel, a market research company, US consumers are increasingly switching to dairy alternatives, such as almond and soy milk. For instance, in the five years ended in 2017, the sales of dairy milk decreased by 15% while that of dairy alternatives grew by 61%. The trends pose a challenge to Dean Foods, due to its lack of diversification and its dependency on its dairy products, especially fluid milk (see Figure 2b). Other top dairy processors such as Saputo Inc. are not significantly affected by the fluid milk consumption trend as unlike Dean Foods, Saputo Inc's operation in the US focuses more on cheese production, which per capita consumption is constantly increasing (see Figure 2a).

Dean Foods formerly owned WhiteWave, the producer of Silk almond and soy milk. However, Whitewave was put up for public offering and separated from the company in 2013. Shortly after, it was acquired by Danone which sought to diversify its portfolio. Recently, to cope with the changing trends, Dean Foods has taken on the majority ownership of [Good Karma](), a plant-based food and beverage company that markets flaxseed milk and yogurt. However, Good Karma has yet to produce meaningful earnings for Dean Foods.

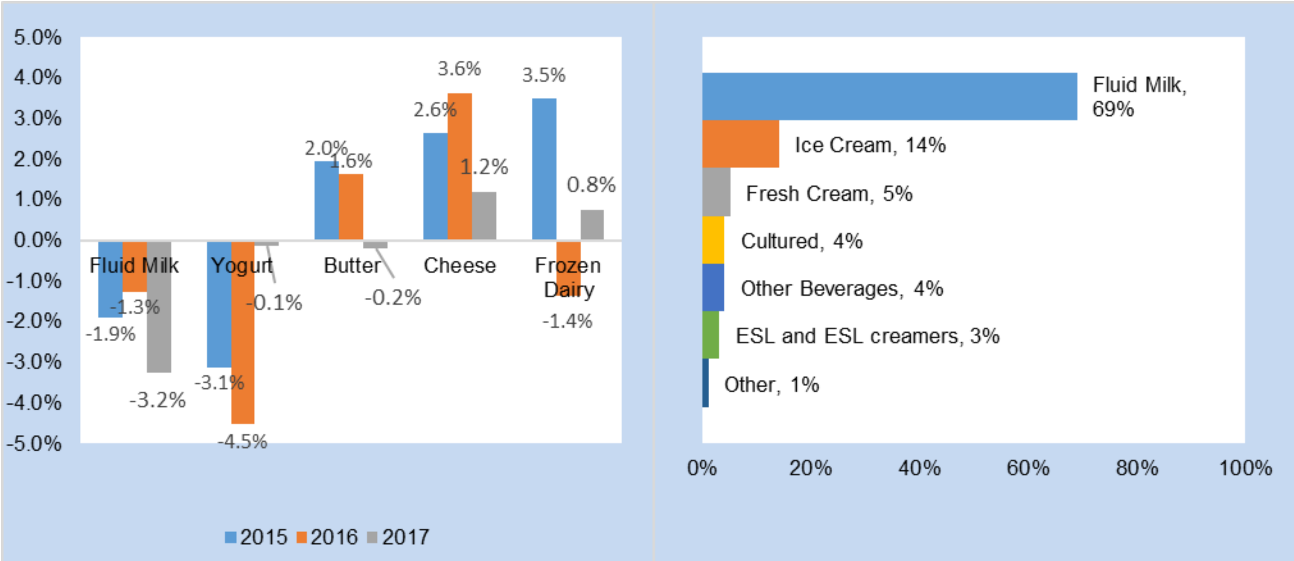

Figure 2a & 2b: Y-o-y change in per capita consumption of dairy products in the United States and distribution of Dean Foods sales worldwide in 2017 by product category. *Source: Statista, USDA, Dean Foods.*

Input cost inflation such as increased fuel expenses in the third quarter of 2018 as well as increased resin and freight costs also contributed to Dean Foods' struggle, as mentioned in its [third quarter financial result for 2018](). Looking at other inputs, Dean Foods' raw material input largely consists of "Class 1 Milk", which is used for fluid, or beverage milk products (69% of Dean Foods' sales in 2017, See Figure 2b). While the price of Class I Milk over the past year has been relatively lower than previous years, the base price of Class I Milk over the past year has been on an increasing trend as seen in Figure 3. If the trend persists, this will put additional pressure on Dean Foods' profit margins.

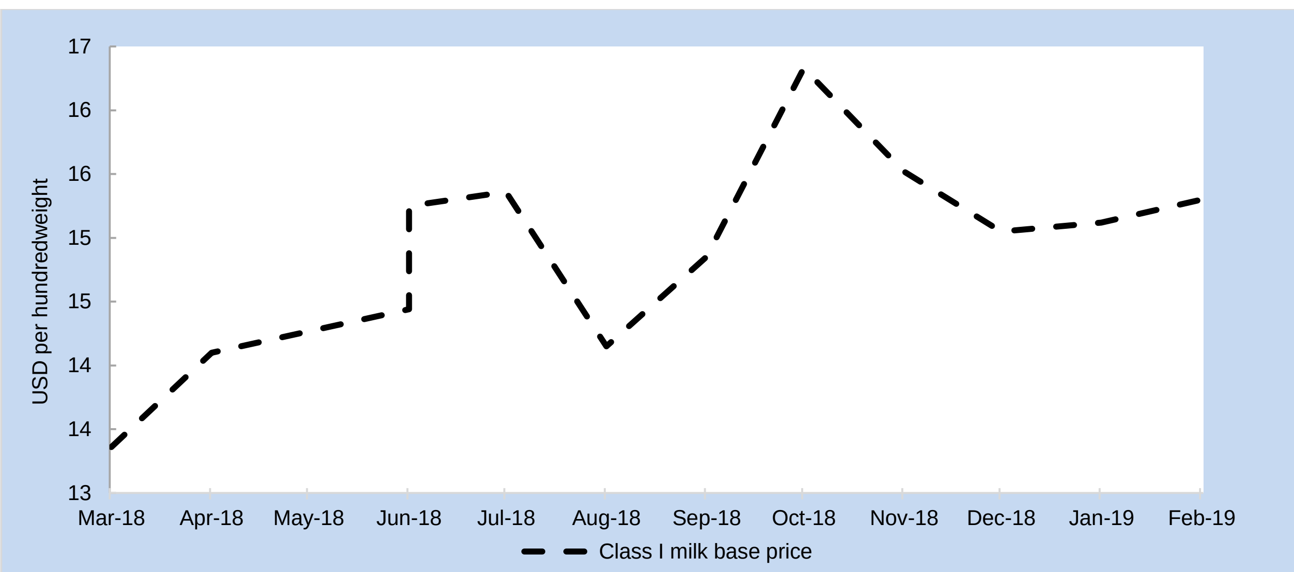

Figure 3: Past year class I milk base price. *Source: USDA.*

Given the challenges elaborated above, in the third quarter of 2018, Dean Foods Co reported an earning per share of negative USD 0.28, [missing the consensus estimate]() of negative USD 0.06. Dean Foods also [lowered its full-year 2018 guidance](), as it anticipates an adjusted net loss for the full year in the range USD 0.1 to USD 0.3 per diluted share, as compared to the previous estimation of USD 0.55 to USD 0.8 adjusted earnings per diluted share it [anticipated in early 2018]().

As seen in Table 1, the revenues earned by Dean Foods remain relatively constant while its EBITDA has a downward trend, signifying its declining profitability and weakening fundamentals. Dean Foods' worsening credit profile is also reflected in the increasing trend of its Total Debt/T12M EBITDA, which reached 6.23 in Q3 2018.

	2017Q1	2017Q2	2017Q3	2017Q4	2018Q1	2018Q2	2018Q3
Revenue (USD mn)	1,995.7	1,926.7	1,937.6	1,935.0	1,980.5	1,951.2	1,894.1
EBITDA (USD mn)	80.1	91.6	114.7	97.3	70.2	75.1	26.0
Net Income (USD mn)	12.7	19.6	34.6	27.2	12.9	14.9	-18.3
Total Debt/T12M EBITDA (X)	2.35	2.57	3.08	3.49	3.34	4.81	6.23

Table 1: Financial figures for Dean Foods Co. *Source: Bloomberg*

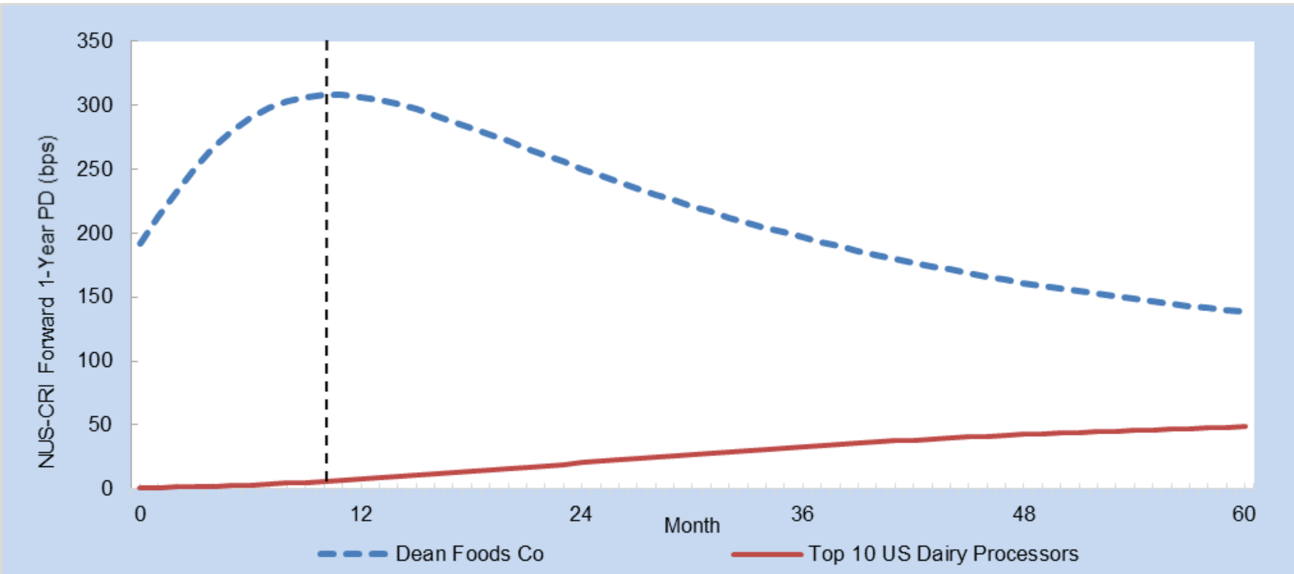

Figure 4: NUS-CRI Forward 1-year PD term structure for Dean Foods Co and Forward 1-year Aggregate PD term structure for top 10 publicly-listed US dairy processors on February 8, 2019. *Source: NUS-CRI.*

Figure 4 illustrates the term structure of the NUS-CRI Forward 1-year Probability of Default (Forward PD) for Dean Foods Co. As illustrated in the figure, based on the market information available as of February 8, 2019, the credit profile for Dean Foods could deteriorate in the following 10 months. The Forward PD computes the credit risk of a company in a future period, which can be interpreted similar to a forward interest rate. For example, the 10-month Forward 1-year PD is the probability that the firm defaulted during the period from 10 months onwards to 1 year plus 10 months, conditional on the firm's survival in the next 10 months. The figure asserts that the credit profile of Dean Foods Co would deteriorate further in the upcoming months.

Currently, Dean Foods is implementing its enterprise-wide cost productivity plan, which is expected to deliver USD 150mn in incremental annual run-rate savings. The strategies include re-scaling of its supply chain, optimization of spending and integration of operating model along with minimization of expenses. As of today, Dean Foods have rescaled its supply chain by shutting down seven manufacturing facilities and redistribute the volume to 23 other plants. Evidently, Dean Foods also seek to rediversify its portfolio as seen from its deals with Good Karma and acquisition of Uncle Matt's Organic Juices. It remains to be seen if Dean Foods' strategies would pay off in the long-term.

Credit News

Deutsche Bank's funding woes deepen

Feb 11. Among leading international banks, Deutsche Bank has had to pay the highest financing rates on the euro debt market this year, further supporting evidence that it is struggling to reduce its funding cost. The bank recently paid 180bps and 230bps over the benchmark for a 2-year and 7-year bond respectively, significantly higher risk premiums than almost all other European banks. Despite the high funding cost, Deutsche Bank stated that its problem in the debt markets were not materially impacting its business or forcing it to change strategy, pointing out that it was still mainly funded by deposits. The bank also states that it is able to issue cheaper covered bonds and had the capacity to repay all outstanding debts. Analysts at DZ bank stated that the high spreads reflect Deutsche Bank's high idiosyncratic risk, which is rooted in the lender's weakness in earnings. (FT)

Loose lending keeps Japan's 'zombies' shambling along

Feb 11. Amid low interest rates and a recovery in the economy, Japanese banks are ramping up lending to small and midsize businesses, even to "zombies" companies that are barely surviving with little hope of repaying their debt. The total domestic loans by Japanese companies came to JPY 504.4 tn, the largest amount since 1997. The trend of loose lending is one of the negative side effects of the large amount of liquidity unleashed by the central bank's large-scale monetary easing. The increase in risk assets like loans together with shrinking profits from the fierce competition among banks which reduces their interest margin have squeezed regional banks. The banks' capital-to-asset ratio now stands at about 10%, still significantly above the 4% minimum requirement, but down from around 12% in 2012. Japanese banks are also increasingly turning to overseas for new sources of income. (Nikkei Asian Review)

Jaguar Land Rover considers financing options after shock writedown

Feb 8. After a USD 4bn writedown, Jaguar Land Rover (JLR) stated that it is seeking alternative funding as conditions are not suitable for it to borrow from the bond market amid a slump in China sales and Brexit uncertainty. JLR needs to raise USD 1bn within 14 months to replace maturing bonds while it burns cash on its investment on electric cars program. To raise funds, JLR could increase a receivables facility or turn to other bank financing, with further options including leasing assets and tapping export credit. Bloomberg data showed that the price of JLR's 4.5% bonds maturing in January 2026 have dropped to a low of 77 cents on the euro, equivalent to a yield of about 8.9%. (Bloomberg)

China's newly global companies falter under local debt load

Feb 6. Chinese companies have spent over USD 1tn on overseas assets and construction between 2013 and 2017 and some of these Chinese global holdings are now facing domestic financial difficulties. The squeeze on credit in China makes these Chinese companies harder to access the credit market. The total social financing, a broad gauge of credit growth in China, has been falling since late 2016. For the past six months, some Chinese companies that participated in the buying boom are showing signs of distress as credit tightens. Some comapnies have already been forced to sell their overseas prizes. The shadow banking market, an alternative source of credit for some of these companies, have also been shrinking which affects the health of their balance sheets. (FT)

Debt-laden borrowers revel in Europe's buyout boom

Feb 6. The European market for leveraged loans has been buoyed by a flood of capital in recent years invested in collateraised loan obligations structures. The influx of money has come at the expense of protections for investors. 88% of covenant-lite loans are being issued across Europe as compared to only 7% in 2007. Covenants are investor protections requiring borrowers to maintain key financial ratios such as keeping debt below a certain multiple of operating profits. Regulations in the form of guidance from ECB have also been of little use to curb banks' appetite for underwriting these riskiest deal. More European loans are also utilising the language from high-yield bond documents written in New York law which have terms that are untested in Europe in the event of restructurings. (FT)

SGD bond market starting 2019 with a bang (Business Times)

Global thirst for bonds has investors scooping up Italian debt (Bloomberg)

Government borrowing set to hit record USD 11tn this year, OECD says (FT)

Regulatory Updates

Bank of England joins dovish global peers putting rates on hold

Feb 8. The Bank of England (BoE) has signaled that UK interest rates would remain on hold following concerns on its economic growth in view of Brexit uncertainty as it cut its forecast for UK growth in 2019 to 1.2% from 1.7%. The European Commission has also slashed its forecast for Eurozone growth from 1.9% to 1.3% for 2019. BoE joined other central banks in sounding a dovish tone in their monetary policy. The Reserve Bank of India surprised markets by cutting its main interest rate by a quarter point ahead of elections. Central banks such as the Federal Reserve have put on hold plans to tighten policy until there are signs of renewed growth while the Reserve Bank of Australia has changed its guidance to say that it is more likely to decrease its rates than to increase. (FT)

ECB to test how long banks can last without fresh funds

Feb 7. The European Central Bank (ECB) will assess the liquidity profile of banks by the number of days they remain in operation without any access to funds. The tests which end in June, will check the lenders' liquidity management abilities in the event of a capital shortage. The ECB is conducting an extra level of checks on banks after elevated volatility in financial markets during December affected the credit quality of some European banks. Last month, the central bank did not hesitate to take reins of Italian lender Banca Carige to prevent a systemic crisis to the wider banking system. (FT)

Fed gives banks more stress test information, unveils 2019 scenarios (Reuters)

RBI eases corporate debt investment norms for FPIs (Economic Times)

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