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## Dairy Situation and Outlook – October 2015

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Six key drivers of the Australian Dairy Industry

**Inputs**

Input costs are adding to the margin challenge for many Australian farmers. The start to spring has been hot and dry, impacting on grain and hay production. For many, irrigation water remains a serious constraint. Cull cow numbers remain significantly elevated.

**Global supply**

Excepting NZ, growth in global milk production has largely defied lower dairy commodity prices. Although the rate is slowing, continued expansion in Europe and the US suggests the supply-side adjustment needed to balance market fundamentals remains some way off.

**Global economy**

The International Monetary Fund has slightly lowered its expectations for 2015 global economic growth. Recovery in advanced economies is expected to drive accelerated growth in 2016, albeit moderated by a relative slowdown in emerging market economies.

**Australian market**

Volume trends are mixed, but supermarket sales of the major dairy categories continue to grow in value. Dairy spreads are growing strongly, while UHT and flavoured products are behind incremental growth in milk sales. Cheese, yoghurt and dairy snack volumes declined.

**Global demand**

Global demand growth has been relatively small, has largely come from price sensitive countries, and has slowed in recent months. While global exports to Greater China and Russia are down significantly, those to Japan are seeing the strongest growth in years.

**Exchange rates**

The USD has appreciated against most other currencies, including the AUD, since mid-May. Key exceptions include the Euro, yen and renminbi. Other import market currencies are lower against the USD, limiting gains from depressed dairy commodity values.
Executive summary

Improved market sentiment has seen global dairy commodity prices begin to rise from their recent extreme lows. Factors such as a deteriorating milk production outlook for New Zealand and reduced GlobalDairyTrade (GDT) offer volumes have helped to drive this lift, but further rebalancing of supply and demand is required if prices are to match or exceed ‘average’ levels in the short term. Global milk production has continued to grow in defiance of the dramatic falls in international dairy prices over the past year and a half, although tighter margins on farm have seen slowing in many regions. At the same time, demand growth has been relatively small, has largely come from price sensitive countries, and has slowed in recent months. Hence the wholesale adjustment needed to balance market fundamentals still appears some way off, and is not generally expected before mid-2016.

Australia is among the major exporting regions globally in which milk production continues to expand. Though there are wide regional variations, margins remain positive (if significantly tighter) for most farmers, allowing them to maintain or incrementally grow milk production. After solid growth of 3.8% in 2014/15 (to a total of 9.7 billion litres), Dairy Australia’s overall forecast is for a 2% increase in national production for 2015/16, with a range of 9.8 to 10 billion litres considered likely.

Corporate activity hasn’t slowed either, with capital raisings, mergers and acquisitions, and new investments making the news. In particular, Murray Goulburn successfully completed the implementation of its new capital structure with the listing of the MG Unit Trust on the ASX. Beston Global Food Company also listed, while A2 Milk Company is seeking to raise NZ$40 million in new equity via shares. Fonterra has recently opened its upgraded bottling plant at Cobden, and Harvey Norman acquired a stake in dairy operator and cattle breeder Coomboona Holdings. Hope Dairies put its dairy investment plans on hold, and Australian Fresh Milk Holdings completed the purchase of Moxey Farms.

High input costs are adding to the margin challenge for many Australian farmers, and the hot, dry start to spring due to El Niño may prompt more conservative operational decisions. Water availability and affordability remain a serious production constraint in irrigation regions, while feed grain prices are still relatively high. The finish for the current Australian winter crop will play a role in determining whether this continues. Carry over of quality hay will be limited in most regions, and there is a high degree of regional variation in expectations for the new season crop.

The four major export manufacturers announced 2015/16 opening price averages of $5.60/kg MS, with other milk processors in southern Australia flagging similar levels. Following a continued easing of international commodity prices, a number of manufacturers flagged the possibility of a ‘step down’, although guidance now more commonly indicates that the opening price is an appropriate budgeting baseline. Farmgate prices have been more stable in northern regions, but terms of trade for farmers in these areas remain difficult for many farmers in these regions.

Factors widely credited with slowing the pass-through of falling global commodity prices to the farmgate include exporter product mixes and strategies, the lower Australian dollar, and the strength of the Australian domestic market. Whilst volume trends are mixed, supermarket sales of the major dairy categories continue to grow in value. White UHT and fresh flavoured products are significant contributors to increased milk sales (+0.8%), with an ongoing trend toward full fat product. Butter is still driving the outstanding growth story in dairy spreads (+4.8%), while cheese sales volumes continue to fall (-2.0%), and unit pricing rise. Yoghurt and snack sales fell (-3.7%), with traditional yoghurt an increasingly popular purchase, at the expense of sweetened and snack type products.

Back at the farmgate however, high prices for manufacturing beef and continued margin pressures mean that cull cow numbers remain significantly elevated. Concurrent reduced heifer demand and prices are encouraging farmers to take the opportunity to replace older and less productive cows, reversing the trend of recent years toward reduced culling to support heifer exports.

Culling is reportedly also tracking at high levels in New Zealand; a factor expected to contribute to a fall in milk production over the 2015/16 season, following two record-breaking years. The bulk of the decline is expected to be in the second half, as per-cow production falls on slowing pasture growth and reduced supplementary feeding to cope with tighter margins.

Growth in European milk production in the months since the elimination of quotas has fallen short of some of the
more ambitious projections, but continue to weigh on global markets. Despite recent farmer protests (prompting announcement of further support from the European Commission), the 28 member bloc increased production by over 400 million litres (+0.6%) year-on-year in the six months to June. This represents roughly half the total growth across the world’s four major exporting regions. The removal of milk production quotas (and subsequent supply growth) has coincided with the closure of the Russian market to European product, with the result that European exporters have been aggressively pricing their product in traditionally ‘Oceania-dominated’ export markets.

Strong demand within the United States for butterfat and a firm cheese market have helped to largely insulate the US dairy industry from global price movements in recent months. In conjunction with a stronger US dollar, this has seen exports fall sharply year-on-year. On farm, margins are still encouraging production expansion, though widespread issues with fodder quality are expected to constrain per-cow milk output in coming months.

Subdued demand and persistent inventory issues saw total global exports to Greater China fall 17% in volume terms in the 12 months to June, whilst Russia has also seen volumes plummet (down 76%). In Russia’s case, the embargo on major (western) exporters will likely persist as late as 2018, according to local sources, greatly restricting demand from what had been the world’s second largest single country dairy market. South American exporting countries have recently moved to focus on sales to both Russia and China, despite milk production dipping below year-earlier levels.

On a brighter note, global exports to Japan, Australia’s largest market in value terms for dairy, grew strongly (+10%) in the 12 months to June, and many Southeast Asian countries continue to take advantage of depressed global prices to stock up on dairy products. This is not surprising, given the benchmark SMP price for Dairy Australia’s affordability index has eased a further 8-10% since the June Situation and Outlook report. Coupled with recent currency movements, dairy has become more affordable in most major import markets, with Japanese buyers the biggest winners in recent months. Dairy price premiums relative to non-dairy substitutes have continued to fall, but may be approaching their respective floors. These purchasing opportunities have prompted many buyers to re-stock. However, buyers in some markets (such as the Middle East) now have their immediate needs covered, causing the pace of imports to moderate.

Market access prospects have benefited from an historic period of increased trade liberalisation over the past few years. The conclusion and signing of the China Australia Free Trade Agreement created strong positive sentiment and a significant boost to farmer confidence, and the Australian dairy industry is strongly supporting the agreements ratification and entry into force. More recently, after more than five years of negotiations, the Trans-Pacific Partnership Agreement (TPP) was concluded on 5th October. The Australian Dairy Industry Council (ADIC) has acknowledged the completion of negotiations as delivering modest but important gains in global market access, including improving on the Japan Australia bilateral agreement, delivering new access into the highly protected Canadian dairy market, and improved access in the United States.

While the benefits of improved market access will be realised in the longer term, in the short to medium term it will be market fundamentals that determine dairy price movements.
The weighted cost and income indices consider the near-term outlook and highlight the net impact of market changes. The latest update suggests:

- Lower year-on-year farmgate milk pricing and ongoing input cost pressures resulted in tighter 2014/15 margins relative to 2013/14.
- The base case outlook reflects an assumed farmgate price around the 2015/16 season opening price.

Current market indications are that the cost base will remain a challenge moving into the second half of the 2015/16 season.

- The likely combination of higher input costs and a relatively subdued short-term farmgate price outlook will increase margin pressure further in 2015/16.

Opening milk prices

The four major export manufacturers (Murray Goulburn, Fonterra, Bega/Tatura and Warrnambool Cheese and Butter) all announced 2015/16 opening price averages of $5.60/kg MS, with few changes to payment structures for the season. Other milk processors in southern Australia flagged similar pricing levels, and most commenced the season with closing price guidance in the range of $5.80 to $6.20/kg MS. Following a continued easing of international commodity prices, a number of processors have flagged the possibility of a ‘step down’ from their opening price during the course of 2015/16. Others have adjusted their guidance to reflect a much lower likelihood of ‘step up’ payments, indicating that in their view the announced opening price is an appropriate budgeting baseline. The common message from all processors to their suppliers appears to be that caution is prudent; despite the recent recovery in prices, current market volatility has added an extra degree of uncertainty to the forecasting task.

Source: Dairy Industry Farm Monitor Project, Dairy Australia analysis
**Inputs**

### Fertiliser

<table>
<thead>
<tr>
<th>Product</th>
<th>Price</th>
<th>% Change LY</th>
<th>% Change 5Y</th>
<th>Volume/Head</th>
</tr>
</thead>
<tbody>
<tr>
<td>Urea (granular Middle East)</td>
<td>285 US$/t</td>
<td>-15%</td>
<td>-24%</td>
<td></td>
</tr>
<tr>
<td>DAP (US Gulf)</td>
<td>436 US$/t</td>
<td>-3%</td>
<td>-9%</td>
<td></td>
</tr>
<tr>
<td>MOP (granular Vancouver)</td>
<td>320 US$/t</td>
<td>+8%</td>
<td>-21%</td>
<td></td>
</tr>
</tbody>
</table>

*Price is August 2015 average, compared to the 2014 (LY) and 5-year (5Y) average. Source: Bloomberg*

### Water and weather

<table>
<thead>
<tr>
<th>Location</th>
<th>Price</th>
<th>% Change LY</th>
<th>% Change 5Y</th>
<th>Volume/Head</th>
</tr>
</thead>
<tbody>
<tr>
<td>Northern Victoria</td>
<td>201 $/ML</td>
<td>+131%</td>
<td>+116%</td>
<td>372,882 ML</td>
</tr>
<tr>
<td>Murray Irrigation System</td>
<td>201 $/ML</td>
<td>+112%</td>
<td>+116%</td>
<td>11,610 ML</td>
</tr>
</tbody>
</table>

*Price is YTD FY 2015/16 (to August), and compares to year earlier (LY). Volume of water traded is YTD FY, and compares to the 5-year average (5Y). Source: Victorian Water Register, Murray Irrigation Ltd*

### Cows

<table>
<thead>
<tr>
<th>Category</th>
<th>Price</th>
<th>% Change LY</th>
<th>% Change 5Y</th>
<th>Head</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cull cows</td>
<td>468 c/kg</td>
<td>+60%</td>
<td>+45%</td>
<td>19,390 head</td>
</tr>
<tr>
<td>Dairy cattle exports</td>
<td>8,333 head</td>
<td>+106%</td>
<td>+98%</td>
<td></td>
</tr>
</tbody>
</table>

*Price is August 2015 average, compared to year earlier (LY) and 5-year (5Y) averages. Number of head is YTD FY 2015/16 (cull cows to August, dairy cattle exports to July). Source: NLRS, ABS*
Fertiliser

Victorian dairy farms participating in the 2014/15 Dairy Farm Monitor Project spent $0.41/kg MS on fertilizer on average, applying 124.7kg/ha of nitrogen, 19.4kg/ha of phosphorous, 33.1kg/ha potassium, and 19.6kg/ha of sulphur. This represented 7.6% of their variable costs for the year.

While the weak AUD has the potential to put upward pressure on local fertiliser prices, global fertiliser markets remain subdued compared to long run averages. This is being influenced by relative prices of fertiliser and agricultural commodities, and various policy issues. On a global scale, relatively low prices for and high inventories of agricultural commodities is not encouraging strong fertiliser demand. Demand is being influenced by policy issues in a number of countries, with a prominent example being China - who account for roughly 30% of global fertiliser consumption - capping total growth in use at 1% annually from 2015 to 2020. No further growth will be permitted beyond 2020. At the same time, efficiency gains in developed countries are responsible for declining nitrogen demand growth. Increased demand for fertiliser is being driven by fertiliser subsidy schemes in Sub-Saharan Africa, where agricultural development is also increasing – a factor also driving increasing demand from Latin America.

The International Fertiliser Industry Association expects a continued decline in nitrogen demand growth rates until 2019/20, modest growth in demand for phosphorus, and firm growth in demand for potassium.

Water

Irrigation water availability and affordability remains a serious production constraint in the Murray Dairy region and on the Murray River in South Australia, due to a combination of dry conditions, low seasonal water allocations, and less water overall for irrigation use under the Murray-Darling Basin Plan.

High Reliability Water Share allocations as of 15 September 2015 were 66% in the Goulburn and 68% in the Victorian Murray systems, compared with 100% at the same time in 2014. General Security water share allocations in the NSW Murray system are 4% as of 15 September, compared with 28% at the same time last year.

Low natural rainfall and reduced water availability are driving increased competition in the temporary market and upward pressure on prices. Temporary water has traded at more than $200/ML since July, compared with a range of $78/ML to $110/ML over the same period the year before. Anecdotally, irrigators with carryover are drawing down heavily on their reserves to meet their production needs this season.

Weather

After a particularly dry September across much of the continent, large areas of southern Australia experienced an exceptionally hot start to October, unusual for both its intensity and duration. Parts of Western Australia, South Australia, Victoria, New South Wales and Tasmania were impacted, with records set in Victoria and Tasmania. By September, 50% of Victoria was affected by severe rainfall deficiencies at the 14-month timescale, according to the Bureau of Meteorology, with serious deficiencies also impacting parts of Tasmania, South Australia, and Western Australia.

El Niño continues to strengthen, and is expected to peak around the end of the year, weakening rapidly into autumn 2016. Atmospheric and oceanic indicators have recently been at levels not experienced since the 1997-98 El Niño, and most models suggest that a positive IOD event is likely. Winter-spring rainfall is generally below average over eastern Australia during an El Niño, a pattern usually given additional strength in southeastern and central Australia by a positive IOD. However, the Indian Ocean is warm (to record levels), and likely to remain so, offsetting typical
El Niño weather behaviour in central and some southern areas. These combined influences result in a spring rainfall outlook from the Bureau of Meteorology showing an equal chance of above or below average rainfall in eastern and northern Australia. Western and central Australia are likely to be wetter than average. Most of Australia is likely to experience warmer than average nights, and warmer days are also likely for far southwest WA and along the east coast of Australia.

Grain

Home grown feed made up 59% of total metabolisable energy (ME) consumed on the average Victorian dairy farm participating in the 2014/15 Dairy Farm Monitor Project, leaving 41% to be purchased from other sources. Purchased feed per milker totalled 2.4t DM/ha, with expenditure on grain/concentrates/other of $1.49/kg MS, representing 27.9% of variable costs. The average hay price was $251/t DM, with fodder purchases costing $0.30/kg MS, and representing 5.5% of variable costs.

Feed grain prices have been relatively high through 2015, supported by strong domestic demand, low liquidity, volatile global markets, and concerns regarding the 2015/16 harvest. Australian and US wheat is currently priced much higher than the level at which major global importers are able to source product from other regions. According to the USDA September WASDE (World Agricultural Supply and Demand Estimates) report, the 2015/16 global wheat crop is projected to be 731.6 million tonnes, which would be the third consecutive record crop. If global wheat values don’t climb to match domestic prices as the Australian crop develops, either prices will have to fall or domestic stocks will build if Australia has an exportable surplus.

Favourable seasonal conditions in most cropping regions through the early part of the growing season resulted in a forecast increase of 8% in 2014/15 (to 41.4 million tonnes) winter crop production, according to the ABARES September Australian crop report. This was based on production increases in Western Australia, New South Wales, Queensland and Victoria, with South Australian production expected to be broadly similar to last year.

Harvest has started in northern Queensland. The majority of wheat crops in southern Queensland and NSW are also reported to be looking good, and excellent yields in many areas will help to offset the large area lost to chickpeas at sowing. Rain will be key to the outcome for crops in more southern regions. The September ABARES forecast was for national wheat production to be 7% higher than last year, at 25.3 million tonnes. Barley production was forecast to be up 8%, at 8.6 million tonnes, with cautious buying as a result of uncertainty around China’s import program for the year resulting in greater availability of old season crop, and softer prices.

Questions about China’s import program are also affecting sorghum markets, the result being a financial preference to plant cotton in some areas, and reduction in sorghum planting area. The ABARES forecast of 2 million tonnes for 2015/16 was based on a similar area being planted as last season, and average yields. This would have represented a fall in production of 4%, and contributed to a forecast fall in total summer crop production of 2% for the season, to 3.9 million tonnes.

Hay

Going into the new season, carry over of quality hay will be limited in most regions, with consequently reports of higher than usual enquiries for forward purchases. There is a high degree of regional variation in expectations for the 2015 crop.

Harvest is well underway in QLD, and some good yields are being reported, and although production is being impacted by drought in some regions, destocking in these areas is also reducing demand. Most of NSW is experiencing a good harvest with late rains lifting the yield potential of cereal and pasture crops. However, favourable prices are also causing some growers to considering taking crops to grain. Reports from SA are generally positive with yields looking average or above-average in most areas, and limited reports of frost damaged crops may see more hay available for the domestic market.

The hot, dry start to spring has seen the hay and silage seasons brought forward in most Victorian regions, with a general expectation that the pasture silage harvest will be limited, with the focus shifting to hay. There are also large areas of cereal crops (mainly wheat) that
will now be cut for hay, rather than carried through to grain. While there are large areas in the north of Victoria being cut, most are reporting low yields (but good quality), and it is not expected that this will result in a surplus of hay for 2016, and prices are not expected to fall. Stocks of hay and silage are tight in Tasmania, a trend expected to continue into the new season.

Strong oat prices are tempting growers to harvest crops for grain in WA, which could compound the impact of relatively small carryover oat hay stocks. However, conditions are reported as being good to average, and reports of frosted wheat crops suggest that cereal hay of varying quality should be available.

Lucerne hay supply is expected to remain tight, particularly in the eastern states and WA. Key contributing factors are irrigation water supply and price, as well as continued strong demand. This, combined with the below average vetch harvest in southern regions, suggests that lucerne prices for the coming season will remain firm with the possibility of further price rises.

While high price and limited availability of irrigation water in the eastern states may see some growers focus on high production silage crops like maize, in general it is expected that total silage production from irrigation will be below average.

Survey results shows a profitable year for dairy farms in all regions

Victoria’s annual insight into dairy farm performance – The Dairy Farm Monitor Project Report – has shown that 2014-15 was a profitable year across all three dairy regions, with 73 out of 75 participants recording a positive return on assets and 83% reported a positive return on equity.

In 2014-15, participating dairy farms reported average earnings before interest and tax of $244,511, and a return on assets of 5.3%.

Now in its ninth year, the Dairy Farm Monitor Project is a joint initiative between Department of Economic Development, Jobs, Transport and Resources (DEDJTR) and Dairy Australia. Through the project, farm data from Victoria’s three dairy regions (Gippsland, South West, and Northern Victoria), is collected and rigorously scrutinised to measure financial and physical performance.

The average milk price received by farmers dropped 11% (to $6.04/kg MS) from last year’s $6.79/kg MS, which was the second highest milk price in the history of the project. The lower average milk price, higher feed costs and mixed seasonal conditions resulted in a decrease in profits from 2013-14, when average earnings before interest and tax was $367,765 and return on assets was 8.5 per cent.

Climate variability between regions also influenced results. In the north of the state, the season began with a cold, drier than average winter and a potentially productive spring that did not eventuate. The region experienced a milder, wetter summer than last year, although a dry start to autumn delayed the resumption of pasture growth. In the south west, drier seasonal conditions and below average rainfall resulted in less conserved forage being made and lower fodder reserves on hand at the end of the year. In Gippsland, the season was variable with average or slightly less than average rainfall. Fodder reserves in Gippsland were either maintained or increased over the year.

Farmer confidence for the 2015–16 season shows one-in-five farmers predict an improvement in farm business returns and 40 per cent anticipate no change.

The Dairy Farm Monitor Project is now national. The Victorian annual report is available at agriculture.vic.gov.au/dairyfarmmonitor or dairyaustralia.com.au/dairyfarmmonitor

The data collected in the Dairy Farm Monitor project underpins Dairy Australia’s web based tool DairyBase, available free to all dairy farmers at dairybase.com.au

The percentage of dairy farmers who reported a positive return on equity

83%
Grain and hay prices

Australian dairy regions

Grain and hay

The relevant stockfeed wheat available in a region (ASW, AGP, SPW1 or FED1).

Shedded cereal hay: mid-range product without weather damage, of good quality and colour.

Prices are estimates in $/tonne at 25 September, GST exclusive but including delivery and (for grain) an allowance for storage and marketing costs.

Percentage price change compares to the equivalent date 2014.

Source: AFIA, Lachstock Consulting
Cows

High prices for manufacturing beef and continued margin pressures mean that cull cow numbers remain significantly elevated. Financial year-to-date (August) sales were 58% higher than the same period the previous year, and 46% above the 5-year average. Total sales for 2014/15 were 37% higher than in 2013/14, at 75,154 head. The August average per kilogram price was 60% higher than prior year. Australian beef exports to the US have hit 85% of quota, and once the quota is reached, a 21.12% tariff will be payable by exporters. A high proportion of cow carcasses go into the US market, giving this the potential to impact on Australian prices unless US beef supply remains tight enough to push prices for imported product even higher.

Dairy cattle exports totalled 8,333 head for July, more than double July 2014. This followed on from total 2014/15 exports of 73,205 head, a 21% fall from the 92,340 exported in 2013/14, largely on the back of lower Chinese demand. While China remains the primary destination for Australian dairy cattle (86% of 2014/15 exports), demand has been impacted by lower domestic milk prices, postponement or cancellation of some large scale dairy projects, and the opening of the Chinese market to live cattle imports from other origins. The majority of the balance of exports went to various South East Asian countries and Pakistan.

Over the last 10 years (August 2005 to July 2015) Australia has exported 650,897 dairy cattle, with some interesting trends in herd composition. There has been a gradual trend toward increased heifer exports and decreased cull cow sales. Or, to put it another way, as we’ve been exporting more heifers, we’ve been culling less cows. This is reflected by a slight reduction over recent years in the ratio of heifers to cows in the national herd (according to ABS data), suggesting that increased income from heifer exports has come at the expense of an older herd. Increased heifer rearing specifically for export may explain a slight reversal to this trend from 2012/13. Herd renewal seems likely to see this continue into 2014/15–16 as farmers take advantage of high cull cow prices and relatively low heifer prices to replace older and less productive cows.

Plains such as those recently announced by Tianjin Bright and MengDe Dairy Group suggest that heifer sales are likely to remain an important income stream for many dairy farms in coming years. The Chinese dairy consortium have recently purchased a property where they plan to raise heifers to export from Portland to their own quarantine facility in China. They hope to start shipments early next year, with the heifers destined for their Chinese operations, which milk 20,000 cows.

Herd renewal seems likely as farmers take advantage of high cull cow prices and relatively low heifer prices to replace less productive cows.
The Australian market

Supermarket sales

Supermarket sales of the major dairy categories continue to grow in value. White UHT and fresh flavoured milk are significant contributors to increased milk sales, while the trend away from modified milks and toward full fat product continues. Private label continues to gain market share in the fresh white milk category. Butter continues to make the dairy spreads category the outstanding growth story, while cheese sales volumes continue to fall, and unit pricing increase. Traditional yoghurt is an increasingly popular purchase, at the expense of sweetened and snack type products.

<table>
<thead>
<tr>
<th></th>
<th>Milk</th>
<th>Cheese</th>
<th>Dairy spreads</th>
<th>Yoghurts and snacks</th>
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</thead>
<tbody>
<tr>
<td>Volume (m. litres)</td>
<td>1,324</td>
<td>137</td>
<td>46</td>
<td>207</td>
</tr>
<tr>
<td>Year-on-year growth</td>
<td>+0.8%</td>
<td>-2.0%</td>
<td>+4.8%</td>
<td>-3.7%</td>
</tr>
<tr>
<td>Retail value ($ m)</td>
<td>2,047</td>
<td>2,118</td>
<td>413</td>
<td>1,437</td>
</tr>
<tr>
<td>Year-on-year growth</td>
<td>+0.4%</td>
<td>+5.2%</td>
<td>+7.1%</td>
<td>+1.0%</td>
</tr>
</tbody>
</table>

White milk sales grew 0.6% for the year to August, to a total of 1,207 million litres, with the average price ($1.34/L) 1c/L lower than the prior year. Category growth was largely driven by sales of UHT, up 4.9%, while sales of fresh white milk fell -0.2%. The average price for UHT was $1.23/L (down 5c/L), while the average price for fresh product was $1.36/L (down 1c/L). Despite UHT displaying stronger growth than fresh milk, it remains a relatively small share of total white milk purchases, at 15% of the category.

Full cream milk continues to grow at the expense of modified products, with full cream fresh milk sales growing 4.9%, and UHT 12.0%. The only modified white milk product to demonstrate growth was reduced fat UHT, up 3.6%. Flavoured milk sales grew 2.9%, the result of increasing sales of fresh product (up 3.6%), and falling UHT purchases (down 5.6%). The average price of fresh flavoured milk rose 4c/L to $3.72/L, and UHT rose 23c/L to $3.58/L.

Private label fresh white milk continues to take market share from branded product, increasing from 61% to 63%, on a 2.4% increase in sales volume. The average price of private label was unchanged $1.01/L. Branded sales fell 4.3% in volume, with the average price increasing 1c/L to $1.94/L. UHT provides a striking contrast, with sales of branded product up 13.2% in volume, and private label down 7.8%, leaving branded product with 65% of the white UHT market (up 4%). Branded product sold for an average price of $1.37/L (down 8c/L), and private label for $0.98/L (down 3c/L).

Non-dairy milk products continue to proliferate, and sales volumes grew 2.1% on prior year, to a total of 79 million litres: equivalent to 6% of total sales of cow milk products. The average price for non-dairy milk products rose 9c/L to $2.57/L. UHT products make up the vast majority of non-dairy milk purchases, representing 81% of the category, with sales of fresh product shrinking for the last two years. Soy milk makes up the majority (54%) of the non-dairy milk category, but sales are shrinking, being replaced with increased demand for nut milks (such as almond and coconut). White milk makes up 95% of sales, although flavoured milk sales are growing strongly.

Dairy spreads (butter and blends) grew 4.8% in volume and 7.1% in value, contributed to strong sales growth in butter, and increase average pricing for blends. Butter continues to demonstrate...
the strongest growth in the category (+7.7%), driven largely by sales of branded product, up 13.9% (compared to 2.3% for private label). Branded butter now represents almost 50% of the market, with an average price of $11.26/kg, compared to $5.75/kg for private label. Overall, the average price for butter fell 0.5% (to $8.43/kg), resulting in category value growth lagging behind volume growth, at 7.1%. Sales of butter blends increased 1.6% in volume terms, and 7.1% in value due to a 5.4% increase in the average unit price (to $9.79/kg).

Cheese sales volumes continue to fall, declining 2.0% during the year to April. While sales of chilled cheese in most packaged formats fell, smooth or cream cheeses posted the greatest decline, followed by snacking and block cheeses. Specialty or entertaining type cheeses posted strong growth, while sales of deli cheese remained steady. Unit pricing increased across all cheese varieties, with the exception of snacking cheeses, with the average chilled cheese price rising 7.2% (to $13.72/kg), and deli cheese up 6.8% (to $25.53/kg).

Yoghurt and dairy snack sales declined by 3.7% in the year to April, with strong volume growth in traditional yoghurt unable to outpace declines in sweetened or ‘indulgent’ yoghurt and dairy snacks. Total sales value for the yoghurt category increased 2.1%, with stronger unit pricing for both traditional and sweetened products. Although the average unit price of dairy snacks rose 6.9%, an 8.4% decline in sales volumes saw category value shrink 2.1%.

**Australian Economic Settings**

Consumer sentiment remains tenuous, with pessimists having outnumbered optimists for 17 of the last 19 months, according to the Westpac-Melbourne Institute Consumer Sentiment Index. The index fell 5.6% during August, with significant contributing factors being concerns about global and domestic economies. Despite measures of demand for labour showing a gradual improvement, falls in foreign and Australian equity markets, poor economic data from China, and disappointing economic growth in Australia are translating into concern about the local labour market. As a result, unemployment concerns have jumped to their highest point since December 2014, according to the Westpac-Melbourne Institute Index of Unemployment Expectations.

Families’ assessments of their financial positions compared to a year ago, and their expectations about how they’ll be in the year ahead both declined during August. However, both measures are markedly improved compared to where they sat at the same time last year. While there was also a decline in expectations regarding economic conditions over the next 12 months, expectations regarding the outlook over the next 5 years improved. The majority of respondents to the survey continue to expect house prices to rise, although there is increasing pessimism on the issue, and also a decline in the number of respondents who consider it a good time to buy a major household item. This is likely linked in part to the expectation that the low AUD has increased prices. Economic concerns of this kind are expected to flow through to a decreased inclination to spend on eating out, or more ‘decadent’ food items.

![Figure 4 Dairy Australia Food Service Index (YoY turnover growth to July 2015)](source: Dairy Australia, ABS)
Australian per capita consumption of dairy products

Per capita consumption trends have varied quite significantly between the major Australian consumer dairy products (drinking milk, cheese, butter and butter blends, and yoghurt) over the past two decades. These trends reflect changes in consumer tastes and preferences in response to a multitude of variables. Some of these include multicultural influences on food trends, health perceptions around dairy products, manufacturers’ responses to these trends (such as low-fat variants), new product development, flavour and packaging innovations, competitive category offerings, and the distribution (hence availability) of products.

Per capita consumption of drinking milk is currently estimated at around 105 litres, easing back over the last two years. Consumption reached a recent peak when the supermarket channel saw an outbreak of ‘milk price wars’, with one of the major chains reducing its private label price to $1.00 per litre for both full cream and modified products. Nevertheless, consumption remains at very high levels compared to many countries.

Cheese consumption has stabilised in recent years at around 13.5 kg per person, as has the split between cheddar to non-cheddar varieties. Nearly 55% of cheese consumed is cheddar types and the remaining 45% is spread across the wide range of non-cheddar cheese varieties available in Australia.

Annual per capita consumption of butter in Australia is around 4.0 kgs. Consumers to remain interested in the ‘naturalness’ of butter, together with its superior taste and cooking functionality.

Yoghurt is the ultimate ‘healthy snack’ for time-pressed consumers, combining both convenience and health attributes, with per capita consumption at 7.2 kg per year.

Figure 5 Australian per capita consumption of dairy products

Source: Dairy manufacturers and Dairy Australia
Global economy and exchange rates

The International Monetary Fund (IMF) updated its World Economic Outlook (WEO) in July, trimming its overall global growth projection to 3.3%; marginally lower than in 2014. The latest forecast is also slightly lower than that of April’s WEO report, reflecting a slowdown in economic activity, primarily in North America. However, the organisation sees growth accelerating to 3.8% in 2016 as advanced economies benefit from ‘easy financial conditions’, lower fuel prices, improved confidence, reduced unemployment and, in the Euro zone, more neutral fiscal policy. Economic recovery in the Euro zone is considered to be ‘broadly on track’ with the exception of Greece, and the underlying drivers of consumption and investment in the United States remain ‘intact’, despite unexpected weakness in H1 2015. Aside from being major exporters, the US and Europe are also key consumer markets. Another important dairy consumer, Japan, produced stronger than expected growth in the first quarter of 2015, but weaker underlying momentum in real wages and consumption is moderating expectations for the balance of the year, according to the IMF.

Emerging market economies continue to grapple with lower commodity prices and tighter external financial conditions, combined with ongoing structural bottlenecks for some. China’s economic rebalancing, and the geopolitical unrest facing some countries are also contributing to the expected slowdown in overall growth for emerging economies. Despite the differences in trend however, expected growth of 4.2% in emerging economies will still outpace that of advanced economies (a forecast 2.1%).

The IMF notes that risks to global economic activity remain weighted towards the downside, with financial market volatility, slower growth in productivity, and ongoing depression of commodity prices amongst the key headwinds.

The US dollar has appreciated against most other currencies since mid-May; currently sitting around 5% higher on a trade-weighted basis, and 17% above year-ago levels according to the Reserve Bank of Australia’s (RBA’s) August Statement on Monetary Policy. According to the RBA, the dominant influence on foreign exchange markets is the divergence between the interest rate outlook in the US, and other major advanced economies. Whilst US rates are widely tipped to be increased later in 2015 as that economy strengthens, the RBA and many currency market participants expect that other major economies will see their own rates eased or maintained at current levels.

One exception has been the Euro, which has recently appreciated against the US dollar after a prolonged period at lower levels - though it remains around 8% lower than at the beginning of 2015. The weaker Euro has provided a significant advantage to European exporters as milk production swells, enhancing their ability to compete on price.

The weaker Euro has provided a significant advantage to European exporters as milk production swells, enhancing their ability to compete on price.
Global supply and demand overview

**United States**
Strong returns from domestic sales have seen the US largely retreat from export markets, with butterfat and cheese prices well above international levels.

- Export volume trends (tonnes)
  - Total volume change: -8%

- Significant market shifts
  - Lactose (+3%)
  - Cheese (-4%)
  - SMP/NDM (-9%)
  - Butter + blends (-70%)

**Mexico**
The US remains the largest supplier to Mexico, with 79% of the market (down from 86% year earlier).

- Import volume trends (tonnes)
  - Total volume change: +12%

- Significant market shifts
  - Liquid milk (+33%)
  - SMP (+27%)
  - Butter + blends (+14%)
  - Cheese (-24%)

**Europe**
European exporters are presenting fierce competition in many traditionally Oceania-dominated markets.

- Export volume trends (tonnes)
  - Total volume change: +5%

- Significant market shifts
  - European Union (+112%)
  - New Zealand (+91%)
  - Southeast Asia (+74%)
  - South America (+19%)

**Russia**
Global exports to Russia fell 71% following embargoes on key suppliers.

- Import volume trends (tonnes)
  - Total volume change: -71%

- Significant market shifts
  - European Union (-80%)
  - New Zealand (-57%)
  - South America (-17%)
  - East Asia (+8%)

**Japan**
Strongest growth in imports for 12 years.

- Import volume trends (tonnes)
  - Total volume change: +10%

- Significant market shifts
  - European Union (+33%)
  - Australia (+17%)
  - New Zealand (+14%)
  - North America (-10%)

**Greater China**
Demand remains subdued, with milk powder imports severely affected (-47%).

- Import volume trends (tonnes)
  - Total volume change: -17%

- Significant market shifts
  - European Union (-13%)
  - North America (-9%)
  - New Zealand (-40%)
  - South America (-42%)

**Middle East**
Big shifts in key suppliers, but total import volumes have remained steady.

- Import volume trends (tonnes)
  - Total volume change: 0%

- Significant market shifts
  - New Zealand (+26%)
  - European Union (+14%)
  - North Africa (-50%)
  - North America (-44%)

**Southeast Asia**
European Union product displaced from Russian markets is competing hard with Oceania exports.

- Export volume trends (tonnes)
  - Total volume change: +7%

- Significant market shifts
  - SMP (+30%)
  - Liquid milk (+25%)
  - WMP (-27%)
  - Butter + blends (-21%)

**Australia**
Australian manufacturers have returned to an SMP/butter mix, rather than WMP, with the domestic butterfat market leaving little for export.

- Export volume trends (tonnes)
  - Total volume change: +3%

- Significant market shifts
  - SMP (+15%)
  - Cheese (+14%)
  - WMP (-3%)
  - Butter + blends (-10%)

**New Zealand**
With Chinese purchasing well down, milk has been directed away from WMP where possible and into better returning product streams.

- Export volume trends (tonnes)
  - Total volume change: 0%

- Significant market shifts
  - SMP (+15%)
  - Cheese (+14%)
  - WMP (-3%)
  - Butter + blends (-10%)
Global demand

Overview
Growth in global demand has been relatively small, largely come from price sensitive countries, and slowed in recent months. Many Southeast Asian countries continue to stock up on relatively affordable dairy products, while the pace of exports to the Middle East has moderated. Subdued demand from Greater China continues, while global exports to Japan have demonstrated their strongest growth in years. Demand from Russia, hitherto the world’s second largest single country dairy market, has plummeted following the embargo on major (western) exporters, now considered likely to persist as late as 2018.

Greater China
Subdued demand and persistent inventory issues saw total global exports to Greater China fall 17% in volume terms, in the 12 months to June. The impact on value was compounded by the significant fall in global dairy prices, falling 29% (USD). WMP and SMP have been particularly affected, with global export volumes to China falling 54% and 27%, respectively. Infant powder increased 13%, and liquid milk rose 40%, or almost 427,000 tonnes. The only major exporting region to increase sales to China was the EU, with total exports up 13% and increases in most products. China was Australia’s largest dairy export market in 2014/15, despite exports falling 3% (3,529 tonnes). While exports of major products cheese (-8%), SMP (-22%) and WMP (-86%) declined, sales of liquid milk rose 73%.

Dairy farmers in China saw their milk price decrease by 20.1% between early February 2014 and mid-August 2015 (according to the Ministry of Agriculture, China). While many small farms have consequently ceased operating, many medium-sized operations have reportedly responded by scaling up, becoming larger-scale farms and adopting new technology to increase production. Governments in various milk producing regions have also adopted various strategies to maintain the confidence of local dairy farmers, including compensation funds for milk price risk.

Japan
Global dairy exports to Japan grew 10% during 2014/15, the strongest growth in that market in 12 years. Butter (+84%), SMP (+86%) and cheese (+8%) saw the most significant volume increases. Cheese represents 83% of Australia’s exports to Japan (our second largest market for dairy exports), and sales volumes rose 17% (just over 12,000 tonnes) in the year to June. In comparison, EU exports of cheese to Japan grew 29% (just under 12,000 tonnes), partly driven by displaced product that would otherwise have been expected to go to Russia. New Zealand picked up a large share of increased demand for SMP and butter. The total USD value of global exports fell 3% over the 12 month period.

Falls in global prices have come as a relief for cheese companies in Japan. The local consumer cheese market has been performing well, but the mandated price of milk for cheese production has been increased 8% since April in response to tight supply of butter and SMP, and a maximum limit has been set on the volume that can be used for the

Figure 6  Exports to key demand markets (12 months to June)
purpose. This makes it difficult to expand domestic natural cheese production, making it important for the cheese companies to be able to source imported product to maintain markets.

Southeast Asia

Many Southeast Asian countries continued to take advantage of depressed global prices to stock up on dairy products, with volume growing 10% in the 12 months to June, and USD value falling 13%. Individual markets demonstrating substantial shifts include Cambodia, Laos, Malaysia, Thailand and Vietnam, while the Philippines and Singapore also saw growth.

Significant product shifts are primarily in milk powders, with WMP (overwhelmingly from New Zealand) up 26%, whey powder up 10% (mainly from the EU), and SMP up 9% (the biggest volume increases being from Australia and New Zealand). Yoghurt increased 41%, although the majority of product originated within the region.

New Zealand increased their market share from 26% to 29%, while the EU rose from 20% to 21%. Australia held steady at 11%, and North America shrank from 22% to 18%.

Mexico

Although Mexico is not a major market for Australia, with the decline in Russian purchasing, it has become the second largest single-country destination for dairy exports globally: these increased 12% in volume and fell 4% in value in 2014/15. The US supplied 79% of total product purchased (down from 86% the previous year), with New Zealand and the EU, the next largest suppliers, increasing their respective shares from 4% to 7%. Major product shifts were in butter oil, cheese and SMP. Butter oil rose 130% (to almost 26,000 tonnes), with the majority of increased supply coming from New Zealand, while the EU claimed the largest portion of the increased purchases of cheese and SMP, up 16% (to over 115,000 tonnes) and 17% (to almost 233,000 tonnes), respectively.

Middle East

Low global values prompted many buyers to re-stock, causing exports to the Middle East to jump in the 12 months to February 2015. However, as foreshadowed in the last Situation and Outlook report, by February many buyers had their immediate needs covered, and the pace of imports moderated. The result of this was no sign change in the volume of exports to the region for the 12 months to June, while the USD value fell 12%.

Significant product shifts included a 20% increase in exports of WMP to the region (mainly from New Zealand), a 10% fall in cheese (mainly from North Africa and the US), and an 83% fall in milk products (mainly from North Africa). The EU increased their market share from 33% to 37%, and New Zealand from 18% to 22%, at the expense of falling market share for North Africa and the US. Australia’s market share remained at 3%.

Russia

The embargo on major (western) exporters was extended for a full year (to August 2016) in June, and will likely persist as late as 2018, according to local sources. The embargo has caused demand from what had been the world’s second largest single country dairy market to plummet, with global dairy exports to Russian fall 76% in the August 2014 - June 2015 period, compared to year earlier. Argentina have increased exports to Russia 40% (mainly cheese), while exports from China and Switzerland have increased significantly in percentage (but relatively small volume) terms.

The embargo covers imports of a range of food and agricultural products (including dairy) in response to sanctions imposed by over the conflict in eastern Ukraine. Exporting countries affected include the United States, European Union, Australia, Canada and Norway – though exceptions have periodically been made.
Dairy affordability

The benchmark SMP price for Dairy Australia’s affordability index has eased further since the June Situation and Outlook report, steadying 8-10% lower (marking a decrease of 33% since September 2014).

Coupled with recent currency movements, this means dairy has become more affordable in most major import markets, with Mexico and Malaysia amongst the exceptions.

A 24% depreciation in the rouble since June has made dairy around 15% more expensive in Russia – though only 4% above the five year average. At the other end of the spectrum, Japanese buyers have been the biggest winners in recent months, with a 3% strengthening in the yen against the US dollar improving dairy affordability by 10% relative to June. In year-on-year terms, China’s robust currency has made dairy 30% more affordable in local terms, compared to September 2014.

Affordability – Why do we care?

At times when commodity prices are high, it’s the largest, fastest growing, highest paying dairy buyers that capture the most attention. However, when the likes of China and Russia withdraw and prices are low, the more price sensitive markets in Africa, South East Asia, and the Middle East tend to stock up on dairy product.

Basic economic principles are at work: in general, the quantity demanded of a good changes with price, and demand for a product is influenced by the relative price of substitutable goods. In price sensitive markets, this relationship (known as ‘elasticity’) is more pronounced. The relatively high proportion of household income spent on food hampers ability to purchase relatively luxurious products (such as dairy) as they become increasingly expensive. Even as consumers in these markets develop a taste for dairy products, if affording staples (such as rice) is already difficult, consuming milk isn’t a priority. Furthermore, the necessity or temptation to swap to cheaper, plant based alternatives becomes particularly strong as the price premium for dairy products increases.

The quintessential example of this is Africa, where buyers in many countries were effectively squeezed out of the market when it was at its height in 2013. This resulted in global dairy exports to Africa falling substantially year-on-year, followed by a sharp upswing in recent times as pricing has been lower. Improved affordability helps maintain this demand base when prices are high, allowing increased purchasing to support a degree of market balance at the other end of the price cycle, when it’s most needed.
**Dairy substitutes**

Dairy price premiums relative to nondairy substitutes have continued to fall, but may be approaching their respective floors. June saw the premium for dairy protein over soy reach its lowest level since July 2009, as a 28% year-on-year fall in average soy meal values was outweighed by the almost 50% decline in SMP-based dairy proteins. This places it at close to half the five-year average. Recent commentary from the USDA suggests soybean prices are likely to remain depressed in the coming months, with stocks in the US (the biggest supplier) higher than previously expected. Yield expectations in the US are also improving, providing some offset to reductions in forecast production in Canada and Ukraine. On the other hand, SMP pricing is likely to remain steady or edge slightly higher over the coming months, as a production response to low pricing makes its way to the farmgate in major exporting countries.

Meanwhile, the premium for butterfat over palm was the lowest in three years, as palm oil prices eased by 27%, compared to a 25% fall in butter values. A higher premium may be around the corner however; dairy fats pricing has remained relatively robust compared to protein, and the post-June decline in palm oil values shows little sign of reversing in the short term. Strong palm oil supplies coupled with reduced demand from major importers China and the European Union and a bearish soybean outlook have weighed on prices, already under pressure from a falling crude oil market. The current El Niño event could reverse the current pricing trend, as drier conditions may limit production later in the calendar year.

**Figure 8  Dairy price premium vs palm/soy substitutes**

Source: Dairy Australia, Oil World
China (ChAFTA)

FTA negotiations with China commenced in 2005 and concluded in November 2014. The concluded deal is seen as a very positive outcome for the Australian dairy industry.

The agreement was signed by respective Trade Ministers in June 2015, which started the domestic parliamentary approval process towards final entry into force.

The timing of implementation is seen as being crucial. The Australian dairy industry is strongly supporting the entry into force of the China Australia Free Trade Agreement prior to the end of 2015, so that a second round of tariff cuts can occur on 1 January 2016.

The Australian dairy industry has experienced strong positive sentiment and a significant boost to farmer confidence based on the conclusion and signing of the agreement.

Trans-Pacific Partnership (TPP)

After more than five years of negotiations, the Trans-Pacific Partnership Agreement (TPP) was finally concluded on 5 October 2015.

The TPP is a multi-country Free Trade Agreement (FTA) involving 12 negotiating parties: Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, the United States and Vietnam. The other 11 TPP participant nations take on average approximately 40% of the total value and volume of Australian dairy exports each year. Four of these are among the Australian dairy industry’s top 10 trading partners. Approximately 17% of the total volume of world dairy trade occurs between the 12 TPP countries.

The Australian Dairy Industry Council (ADIC) acknowledged the completion of negotiations under the TPP as delivering modest but important gains made for the Australian dairy industry in improving access to global markets.

For dairy, the TPP will provide improvement on the Japan Australia bilateral agreement to eliminate tariffs, more favourable blending ratios on certain cheese products, and some access for butter and milk powders. It also has managed to deliver some new market access into the highly protected Canadian dairy market while delivering an improvement to market access in the United States.

The conclusion of the TPP continues a historic period of increased trade liberalisation over the past few years, following the conclusion of the Korean, Japanese and China* FTAs.

*The China FTA is still to be ratified
Global supply

Overview

With the exception of New Zealand, growth in milk production has largely defied the dramatic falls in dairy commodity prices over the past year and a half. Whilst growth in many regions has slowed, the wholesale adjustment needed to balance market fundamentals still appears some way off.

Figure 9 Actual and forecast milk production growth – four largest exporters

Note: Size of bubble represents export share in MEQ Calendar years for EU/US, production seasons for Aus/NZ
Source: Dairy Australia, USDA, Eurostat, DCANZ

Figure 10 Farmgate price movements – four largest exporters

<table>
<thead>
<tr>
<th>Change in indicative farmgate price</th>
<th>NZ</th>
<th>EU-28</th>
<th>US</th>
<th>Australia</th>
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<tr>
<td>Compared to last report (May 2015)</td>
<td>5%</td>
<td>-3%</td>
<td>0%</td>
<td>-7%</td>
</tr>
<tr>
<td>Compared to prior year (October 2014)</td>
<td>-13%</td>
<td>-16%</td>
<td>-33%</td>
<td>-8%</td>
</tr>
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</table>

Figure 11 Market trends – four largest exporters

Source: Dairy Australia, USDA, Eurostat, DCANZ

Note: Size of bubble represents export share in MEQ Calendar years for EU/US, production seasons for Aus/NZ

European Union

Growth in European milk production in the months since the elimination of quotas has fallen short of some of the more ambitious projections, but remains a major factor weighing on global dairy markets. Overall, the 28 member bloc produced 0.6% more milk in year-on-year terms for the six months to June, representing over 400 million litres, or roughly half of the total growth across the world’s four major dairy exporting regions. Growth is widely varied across member states, with Ireland (up 7.8%) and Hungary (up 7.4%) producing the strongest growth over the period, whilst Romania (down 7.8%) and Cyprus (down 5.3%) saw the steepest declines. Since the expiry of quotas at the end of March, those previously constrained by the quota system have seen particularly solid year-on-year increases, led by Ireland and the Netherlands. To some extent, this has been offset by the effects of lower milk prices constraining production in other areas – most notably the Baltic states (also heavily impacted by the Russian embargo). Farmers in a number of states have begun protest actions as a result of shrinking margins, and the European Commission has responded with an assistance package (see box). However, despite the unrest, milk prices across much of Europe remain conducive to production, and some processors have passed on small increases of late – reducing the likelihood of a pronounced supply response. Most of the EU’s excess milk is being directed to SMP and butter production, given these products are eligible for the intervention and private storage aid (PSA) price support schemes. As of late September, the volume of SMP sold into intervention was just over 20,000 tonnes, whilst a similar tonnage remained in the PSA program. Around 90,000 tonnes of butter is also under storage in PSA. Reports suggest some manufacturers have been prepared to sell into the market at prices below the intervention level in order to maintain cash flow. The sustained depreciation of the Euro against the US dollar is assisting European exporters in their efforts to secure export sales.

United States

Strong domestic demand for butterfat and a firm cheese market have helped to largely insulate the US dairy industry from global price movements in recent months. This disparity between domestic and international prices has, however, posed a severe impediment to US exports, which have fallen sharply year-on-year. On farm, margins are still encouraging production expansion, though widespread issues with fodder quality (due to excessive summer rainfall) are expected to constrain per-cow milk output. There are also significant geographic variances: the Midwest and northeastern states are enjoying more profitable margins and expanding production, whereas margins are tighter and milk output is retreating in the more export-exposed southwestern states (particularly California). Although overall US growth has slowed from 2% in January to 1.5% for 2015 to August, the USDA’s most recent World Agricultural Supply and Demand Estimates (WASDE) report anticipates a slower 1.3% rate (to 94.8 billion litres) across the full calendar year. Given the constraints on per-cow productivity, this will be driven by increases in overall cow numbers – which have continued to grow, but are expected to plateau mid next year – earlier than previously thought.

New Zealand

Milk production in New Zealand is expected to fall over the 2015/16 season, following two record-breaking years. Although culling is reportedly already tracking at high levels (year-on-year) early in the season, the bulk of the decline is expected to be in the second half, as pasture growth slows and per-cow production falls. At that time, consideration of culling, supplementary feeding and reduced frequency milking options takes centre stage. Supplementary feeding has become increasingly popular in recent seasons as a means of extending the production peak and capturing favourable margins, but a return to more traditional practices to cope with tighter (or negative) margins is anticipated this year. Pasture conditions are currently favourable in most regions, however the drier conditions due to the current El Niño event could have a compounding impact, should these emerge. Fonterra’s Farmgate Milk Price forecast is currently NZ$4.60/kg MS (around A$4.55/kg MS), having been boosted in September by a recent commodity price lift on the GlobalDairyTrade auction. The increase in GDT prices has largely been credited to Fonterra’s strategy of reducing forecast offer volumes; in turn attributed to redirection of milk to ‘higher value product channels’, boosting of inventories, and off-GDT sales. Deteriorating New Zealand production expectations have also contributed – both in terms of GDT offer forecasts, and broader market expectations. AgriHQ expects 2015/16 New Zealand milk production will be below year-ago levels; Fonterra is currently forecasting a 5% drop in its full season collections, whilst other analysts have predicted a contraction of as much as 10%.

Australia

Milk production continues to expand in Australia, with favourable seasonal conditions experienced in most regions. Margins have tightened significantly this season, but remain positive for most farmers, so far allowing them to maintain or incrementally grow output. Processor forecasts at the commencement of the season...
suggested many farmers in southern export regions could expect a milk price over $6.00/kg MS, though most have now adjusted guidance towards a lower full year price as dairy commodity markets continued to fall. Some have canvassed the possibility of a ‘step down’ reduction to the opening price, and some are encouraging suppliers to limit their milk production for the season, avoiding further growth where possible. It remains too soon to ascertain the full effects of these signals, or if recent positive market moves will counteract them, however other factors are also likely to weigh on production in the months ahead. In particular, input costs (especially water) are adding to the margin challenge for many farmers, and the dry conditions brought on by the current El Niño event may also prompt more risk averse operational decisions. For the season to August, Victoria, South Australia and Tasmania are all demonstrating milk production growth. Farmgate prices are more stable in northern regions, however cost pressures, volatile seasonal conditions and ongoing structural adjustments have contributed to a further reduction in Queensland’s milk output, while New South Wales is growing (up 5%). Western Australia’s growth spurt continues, with the state’s milk production up 8% for the season to date. Dairy Australia’s overall forecast is for more modest growth of around 2% in national production for 2015/16, relative to 2014/15 – with a range of 9.8 to 10 billion litres considered likely.

**Latin America**

Milk production in the key South American exporting countries has again dipped below year-ago levels, with the latest available data showing Uruguayan output down 2.9% for August, and Argentina down 3.0% in July. Russia’s embargo on imports from other key suppliers has led to an increased focus on that market, with total exports to Russia from the two countries increasing 62% in the first half of the 2015 calendar year. A weak rouble and softer demand have limited the scope of this opportunity however, and reports suggest stocks are building, prompting a willingness amongst sellers to discount product towards Oceania price benchmarks – particularly for WMP. Uruguay has also looked to neighbouring Venezuela, recently inking a deal to supply 44,000 tonnes of milk powder, and 12,000 tonnes of cheese to the country’s state buyers. Uruguayan shipments to Venezuela totalled around 42,000 tonnes in 2014; roughly one third of total Uruguayan dairy exports by volume. Meanwhile, total dairy exports to Brazil are up 39% in volume terms for 2015 to July, with increased milk production within the country targeted at recently secured export opportunities in China and Russia. The conclusion of a deal with China in September will see Brazilian companies competing in crowded milk powder, butter and cheese segments, whilst Russia approved 13 Brazilian dairy plants for export – bringing the total to 26.

**‘Market disturbance’ Europe’s policy response**

European dairy farmers from a number of member states have taken to the streets in recent months, demanding action to protect them from falling farmgate prices. The removal of milk production quotas (and subsequent growth in milk supply) has coincided with the closure of the Russian market to European product, and a weaker international dairy market more broadly. Despite efforts to make the European Union’s (EU’s) Common Agricultural Policy (CAP) more market oriented over the years, the European Commission still employs a number of tools to deal with ‘market disturbances’ such as the current imbalance of supply and demand. These include the Private Storage Aid (PSA) program (which subsidises storage costs for a set period of time), public intervention (where the Commission buys product off the market itself at a set floor price) and export subsidies (financial incentives to dispose of product in external markets). The first two of these have already been activated (see European supply discussion), but a number of agricultural lobby groups and some EU governments are seeking a more interventionist response. In particular, there are calls for the trigger prices for intervention buying to be increased, and for export subsidies to be activated. The European Commission has so far avoided bowing to these calls, with a number of alternative proposals up for discussion, falling into a number of areas. Increases to, and advance payments of direct subsidies, tweaks to increase the generosity of current programs like PSA, and additional steps to promote dairy consumption both in the EU and overseas are amongst them. Some broader steps to improve farmer access to credit, promote income-stabilisation tools, and boost market transparency have also been mooted. The current budget for these measures, should they be approved, is around €500 million (A$796 million). Much of the funding is derived from superlevy penalties collected as part of the now-defunct quota system; effectively representing a transfer from the most efficient, fastest growing producers, to those who are less competitive.
Corporate sector update

The pace of corporate activity has been maintained over the Australian winter, with capital raisings, mergers and acquisitions, and new investments making the news in addition to the annual swathe of opening farmgate price announcements.

Murray Goulburn (MG) successfully completed the implementation of its new capital structure on July 3rd, with the listing of the MG Unit Trust on the ASX. The initial public offering attracted in excess of 6000 new Australian and international investors, at both the retail and institutional level. The initial listing price was $2.10; shares have subsequently traded as high as $2.50 (July 7th) and as low as $1.76 (August 10th), and as at the end of September are trading around $2.25.

An ASX listing was also completed by Beston Global Food Company (BFC), a new entrant to dairy that recently purchased the former United Dairy Power (UDP) factories at Murray Bridge and Jervois in South Australia. The company completed its listing on the 28th of August, with an initial market capitalisation of $127m, and share issue price of 35c. In addition to the two plants, BFC’s dairy interests cover a number of dairy farms in South Australia, and a stake in niche processor Paris Creek.

In other ASX-related news, dual ASX/NZX-listed milk A2 Milk Company received and rejected a joint expression of interest (EOI) to acquire all shares in the company from its biggest shareholder Freedom Foods and US dairy giant Dean Foods. The Freedom Foods/Dean Foods consortium have subsequently abandoned the proposal, and A2 is undertaking an equity raising of its own, via a share issue.

There could be more mergers and acquisitions activity on the horizon, with Brownes Dairy reportedly going on the market. Financial media reports in late July claimed that owner Archer Capital has hired Luminis Partners to sell the WA milk and yoghurt manufacturer. Archer reportedly engaged Luminis after receiving inbound approaches. The business is understood to be making more than $15 million in EBITDA, which could indicate a sale price of $130 to $150 million.

Meanwhile, Burra Foods sought to clarify rumours of its own impending sale, with CEO Grant Crothers confirming that ANZ and Moelis have been tasked with a ‘strategic review’ of capital raising options. The review is expected to take up to six months (from late August), with the ultimate objective a capital injection for further investment in manufacturing capability ‘to make the business more robust and maximize [market] opportunities’.

Fonterra Australia’s investment in a new state-of-the-art milk bottling plant at Cobden was commissioned in September. The Cobden Beverages Plant began production for the Woolworths Select supermarket-brand milk range, and will process up to 100 million litres per year for the next 10 years under the contract.

Whilst Fonterra has begun supply Woolworths private label milk in Victoria, Parmalat has retained the Woolworths contract in New South Wales, recently signing a five year deal (as opposed to its current two year agreement) worth a reported $100 million. In addition, the company won the Woolworths contract in South Australia, at the expense of Lion Dairy and Drinks, which has nonetheless retained its Tasmanian agreement. Brownes supplies Woolworths private label milk in WA.

There was mixed progress in the farm investment space, with Harvey Norman boss Gerry Harvey, taking steps to invest up to $80 million into an intensive dairy farming operation near Shepparton. Harvey Norman subsequently invested $34 million in dairy operator and cattle breeder Coomboona Holdings, acquiring a 49.9% stake and advancing about $9 million to the company. This comes as Gina Rinehart’s Hope Dairies venture put its own dairy investment plans (announced last year) on hold.

Australian Fresh Milk Holdings (AFMH) have completed the purchase of Moxey Farms, one of Australia’s largest single-site dairy operations. The Moxey family have acquired a strategic stake in AFMH as part of the deal, and will stay on to operate the farming business in a joint venture with the Perich family (owners of consortium member Leppington Pastoral). Freedom Foods Group and New Hope Dairy Holdings (not to be confused with Hope Dairies) are also part of the consortium.