



## Dairy 2011 Situation and Outlook

September Update



# September 2011 Update

## About this report

The Situation & Outlook process is designed to provide the Australian dairy industry and its stakeholders with an overview of the entire industry supply chain – from dairy farm inputs to consumer markets.

This is the first update to be released, following the most recent annual Dairy 2011: Situation & Outlook report published in May 2011.

The report has been compiled with input from industry organisations and dairy companies, as well as a range of information sources.

## This updated report:

- Summarises the operating conditions facing the Australian dairy industry supply chain, and ultimately affecting the profitability of dairy farms;
- Summarises the highlights from the follow-up survey to the 2011 National Dairy Farmer Survey conducted earlier in the year; and
- Provides a brief overview of the current industry status and the situation and outlook for the key drivers of the Australian dairy industry.

This Situation and Outlook Quarterly Update is published for information only. It is produced with due care and attention to accuracy, but Dairy Australia accepts no liability if, for any reason, the information is inaccurate, incomplete or out of date.

Copyright Dairy Australia 2011 All rights reserved.

## Table of contents

Australian dairy supply chain	Page 3
Key driver outlook	Page 4
The Australian dairy industry in September 2011	Page 5
National Dairy Farmer August Survey highlights	Page 8

## The seven key drivers

Global economy	Page 10
Global demand	Page 11
Substitute products	Page 12
Australian market	Page 13
Global supply	Page 14
Inputs	Page 16
Exchange rates	Page 18

## Feature article

DPIV Farm Monitor Analysis – Balancing return on equity and risk	Page 19
---	---------

# Australian dairy supply chain

Two-speed industry – export vs domestic

Strong opening prices, high water storage levels and soil moisture, stable grain prices

Too much rain in southern regions will affect early season production

Margin pressures for drinking milk processors facing pressure on retail prices

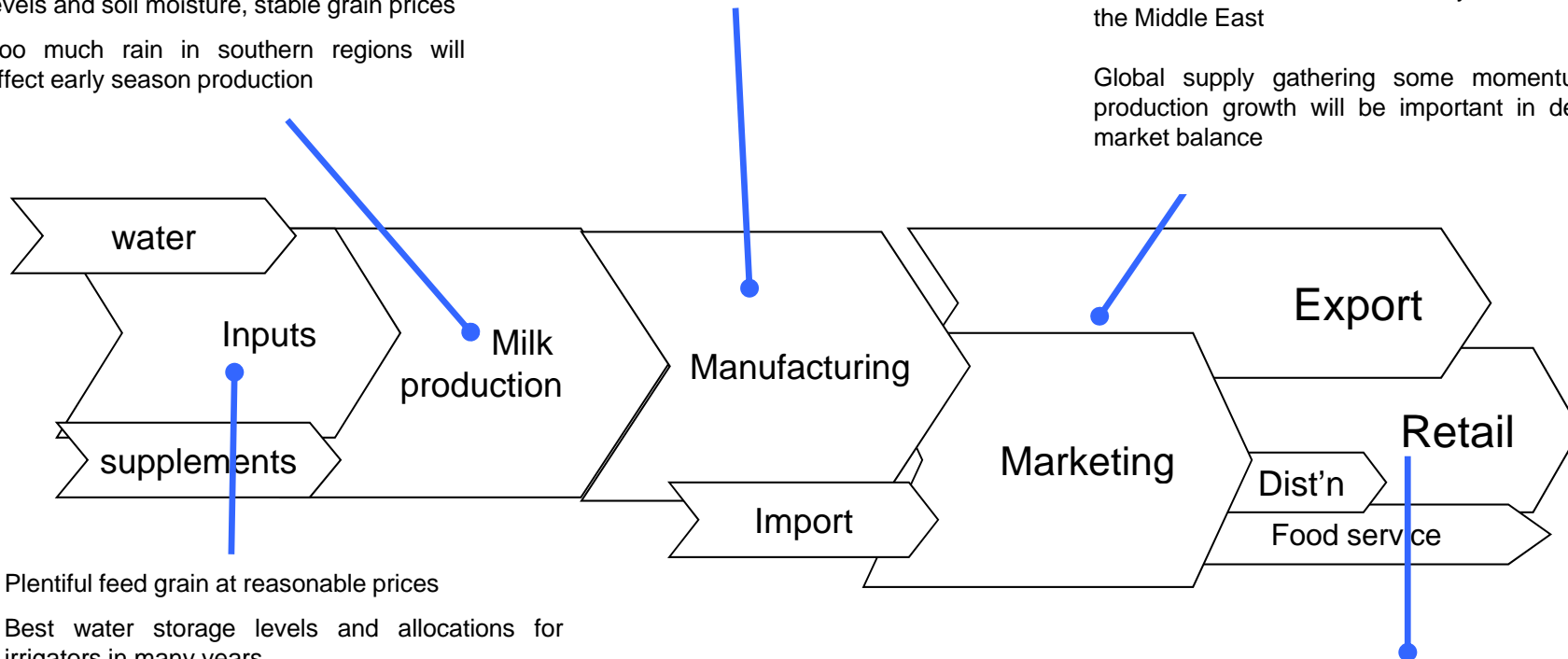
With strong opening prices and market uncertainty, step-ups will be cautious

Dairy market has been steady amid wider economic turmoil

The US dollar remains weak while the US economy struggles to recover.

Demand has been resilient, led by China, Russia and the Middle East

Global supply gathering some momentum – NZ production growth will be important in determining market balance



Plentiful feed grain at reasonable prices

Best water storage levels and allocations for irrigators in many years

High cow prices limiting expansion plans










Potential pasture damage in wet southern regions

Cautious consumers – slow foodservice sales

Trend back to price competitive supermarkets

Downward pressure on retail dairy prices

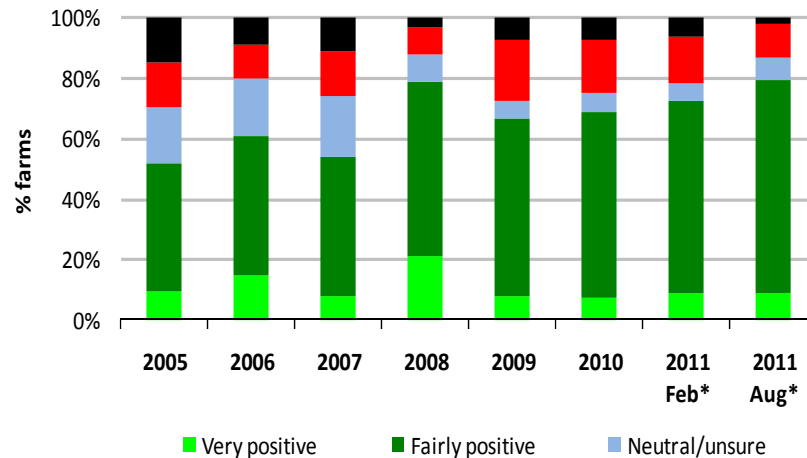
# Key driver outlook

	Global economy	Global demand	Australian market	Global supply	Inputs	Exchange rates
<b>Status</b>						
<b>Major discussion points</b>	<p>Global economic recovery faltering</p> <p>Financial markets remain fragile amid a climate of uncertainty</p> <p>Eurozone debt issues threaten to spread</p> <p>Narrower range of policy options available to respond to financial crisis compared to 2008</p> <p>S &amp; P downgrade of US means higher borrowing costs and more uncertainty in financial markets.</p> <p>Inflation concerns in China.</p> <p>Signs of overheating in emerging markets could raise inflationary pressures.</p>	<p>Overall demand remains resilient</p> <p>The main risk to demand is the impact of the EU and US economic issues</p> <p>Chinese imports remain strong, underpinning global WMP markets</p> <p>Dairy exports to Middle East remain strong</p> <p>Substitution and reduced consumption remain risks in more price sensitive markets.</p>	<p>Consumers remain cautious – saving and deferring consumption</p> <p>Foodservice sector is slow</p> <p>Supermarkets ‘milk price war’ is ongoing – no end in sight from retailers</p> <p>Pressure on profit margins in the domestic market</p> <p>Domestic sales of major dairy companies lifted in the key milk / butter / yogurt categories</p>	<p>Heatwaves in US &amp; EU have hampered milk production</p> <p>Strong start to NZ season, if this continues throughout the season it will have a major impact on world prices</p> <p>Australian production forecast to grow around 1.5%</p> <p>Strong production growth in Argentina likely to increase export availability</p>	<p>Good irrigation water allocations</p> <p>Large volumes of stored hay and silage from wet spring last year – but of lower quality</p> <p>Plentiful local feed grain stocks with prices stable. World prices to be driven by US corn market</p> <p>Lower cull cows and heifer exports as farmers retain cattle for the more favourable season ahead</p>	<p>Major banks forecast AUD to trade in 85-105 US cents range to the end of 2011</p> <p>While the lower end of the forecast range would be welcome, at this stage the AUD remains buoyant</p> <p>Unpredictable currency swings are likely over coming months, due to variable recovery rates in developing and developed economies.</p> <p>A stronger Euro is reducing EU exporter competitiveness.</p> <p>Japanese and Chinese currencies are maintaining import affordability.</p>
<p><b>Operating conditions or key driver status:</b></p> <p>Positive  Steady  Negative </p>						

# The Australian dairy industry in September 2011

- The 2011/12 season has started positively, particularly for southern farmers. **Opening farmgate prices were 3 to 5% higher than last year**, while seasonal conditions are mostly favourable.
- In an update of the February-March National Dairy Farmer Survey conducted in **late August**, **60% of farmers** contacted **described their season as “about where they would like it to be”**. The survey results highlight significant regional differences - while 94% of Murray Dairy region farmers are happy with the season, just 34% of western Victorian farmers are enjoying favourable conditions.
- **While 78% of farmers surveyed in August felt positive about the future of the industry**, there were significant differences based on seasonal and market factors. All regions – with the exception of NSW - were more positive in August than they reported in the earlier survey.

Fig 1 - Farmer attitude to future of the industry



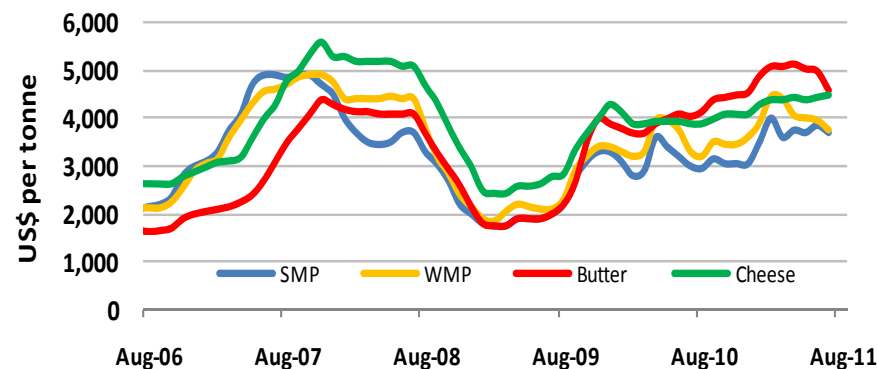
\* Comparing responses from survey update respondents only

- Despite an overall high level of confidence, **the outlook for milk production is mixed**, with a slight drop in herd size reported by farmers in August. Milk production has started slowly, with very wet conditions in southern Victorian regions, and farms still recovering from floods in Queensland and drought in Western Australia impacting output.
- However, a favourable seasonal outlook and opportunities for profitable production should see momentum build in coming months, particularly in the south. As a result, **Dairy Australia is forecasting a 1.5% increase in 2011/12 milk production to 9.25 billion litres**. The subdued production outlook will maintain pressure on companies in southern exporting regions as they compete for suppliers.
- Farmers in **NSW, Queensland and Western Australia** continue to be affected by the **fall-out from supermarket private label supply contract changeovers and discounting**. This is certainly impacting confidence and the short and long term production prospects in these regions. A large proportion of farmers surveyed in these domestically-focussed states **cited milk price as their main challenge for the coming six months**.
- The local dairy market has performed well in a climate of increasing pessimism around cost of living increases and weakening employment prospects. **Consumers continue to be cautious in their spending and food prices remain under pressure**.
- For farmers in southern exporting regions, the focus is on the international market, which has been remarkably steady given the growing turmoil in international finance circles.
- The faltering US economic recovery was dealt a high profile blow with a credit rating downgrade highlighting and compounding debt problems. Unity for Eurozone countries is being threatened by the magnitude of the debt crisis in a growing number of member countries, and their inability to effectively trade their way out of trouble.

# The Australian dairy industry in September 2011

- There is **increasing talk of another financial crisis**, which should it occur, could have **serious implications for commodity markets**. Credit and currency markets are already being affected, adding to the **uncertainty in the current economic outlook**.
- Given the conditions affecting the world's major developed economies the **relative stability of international dairy markets is remarkable**. The question is, will it remain so?
- **International dairy commodity prices have softened in recent months**, with increasing supplies from New Zealand and Latin America in prospect, and production growth in the US and EU.
- WMP prices – as measured by Dairy Australia's spot commodity price series - have fallen 16% from their peak earlier in the year, while SMP and butter spot prices have fallen by 8% and 10% respectively. While these falls are not insignificant, prices remain historically high, and after initial falls from their peaks, **price movements have been limited, despite improvements in supply**.
- **Spot prices for cheese** - Australia's most important export product - **have remained stable**, with neither the earlier peaks or the recent falls affecting spot prices.

Fig 2 - Spot commodity prices (USD/t FOB)



- Critically, **demand for dairy imports remains strong**, supported by China, Asia and the Middle East. Calls for emergency imports by Korea, Japan, Taiwan and India underline the tightness of these markets.
- **China will continue to be an important driver of dairy demand** in the outlook period in two ways. Directly through imports of WMP and other dairy ingredients, and indirectly by supporting economic growth in the region and the wider global economy. This assumes the Chinese government's efforts to curb domestic inflation do not impact too much on economic growth, incomes and demand for dairy products.
- Based on the current outlook for the international dairy market, **Dairy Australia's forecast range for southern prices full year farmgate prices remains at \$5.10 to \$5.50 per kg milksolids (39 to 42 cents per litre)**. However, given the softening in commodity prices and the strengthening of the Australian dollar since the forecast was made in May, **expectations are now at the lower end of the range**.
- While dairy market fundamentals support this price outlook, **developments in the wider global economy, and currency movements will be major influencers on returns to Australian dairy manufacturers**. Current major bank forecasts point to trading range for the Australian dollar between 85 and 105 US cents by the end of the year. Should this forecast be achieved it would be some improvement for exporters.
- Given higher opening prices, this forecast would suggest **limited step up payments to farmers for the remainder of the season**. However, competitive pressures and the market mix and exchange rate strategies of individual dairy companies will determine the final outcome for full year prices.
- While this price outlook is down on final 2010/11 payments, improved seasonal conditions and lowered feed costs should preserve profit margins, making the current season one of consolidation for most dairy farmers.

# The Australian dairy industry in September 2011

## Good news

- The Chinese economy is expected to continue growing at close to the rapid pace set last year, underpinning dairy import demand.
- Stock levels are at comfortable levels, and not influencing market sentiment.
- Asian currencies remain strong against the US dollar, making dairy imports affordable at higher prices.
- Feed grain supplies are plentiful and prices are lower, following downgrade of local crop.
- The majority of Australian dairy farmers are enjoying favourable seasonal conditions.
- Announcement of Murray Goulburn joint venture Tasmanian Dairy Products (TDP) in Tasmania, which will increase demand for the state's milk.

## Bad news

- High unemployment and weak consumer spending will hold back the US economy into 2012, while Europe's debt crisis threatens to infect the global financial system.
- The Australian dollar has traded at an average rate of 106 US cents since May this year, constraining returns to Australian dairy exporters.
- Policy makers now have fewer options for responding to a renewed financial crisis should it occur.
- Flooding is impacting dairy farmers in southern regions – with impact on pasture. Queensland farmers are still dealing with the recovery from floods earlier this year.
- Margin pressure increasing in the domestic market as supermarket discounting activity flows through to non-supermarket or route channels.

## Key questions

- Will the debt problems in EU and US prompt another financial crisis, with a similar impact on commodity trade?
- How will policy and financial market responses to EU and US issues impact currencies? What will be the result for Australia's export competitiveness and the affordability of imports for key customers?
- Will spring rains deliver the expected harvest of grain and fodder crops?
- How will waterlogged southern pastures recover as temperatures rise through spring, and what impact that have on farm profitability and Australian milk production for 2011/12.
- Will the rate of growth in New Zealand milk production be maintained throughout the season, how will this impact market balance?.
- Will increased volumes of Argentinean cheese be absorbed within the Latin American region?

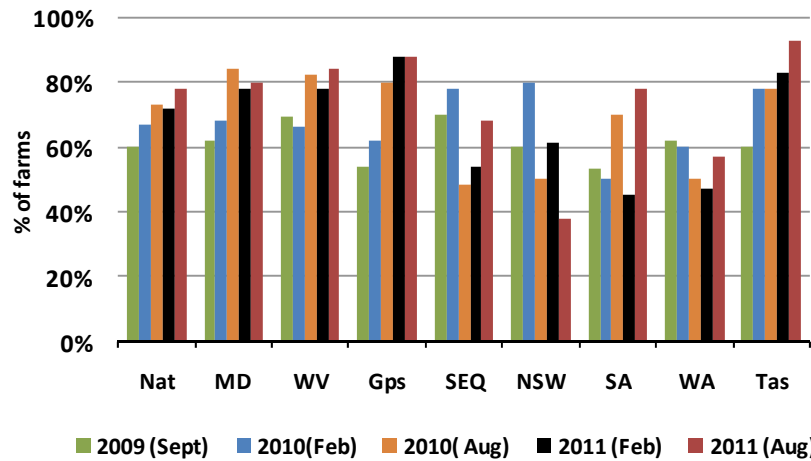
## Issues to look out for

- US moves to keep the USD artificially low to stimulate exports could create exchange rate wars.
- The difficulties of managing a currency across a range of different economies suggests more pain lies ahead for the Eurozone. This may lead to a weaker Euro, and increased competitiveness for EU exporters
- China's ability to manage its inflation problem, the effect that will have on economic growth and demand for dairy imports.
- Release of Murray Darling Basin plan delayed but likely to have major implications for inland dairying regions
- Carbon tax to be introduced in Australia in July 2012. Will raise the cost of production for Australian manufacturers and farmers.
- Middle East unrest – future impacts on GDP growth and demand for imported dairy products.

# August farmer survey

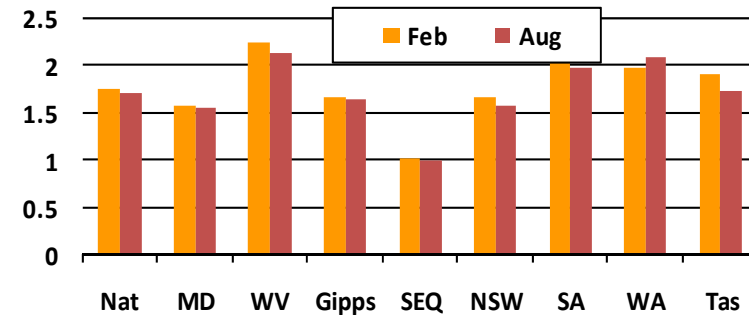
- In late August, 340 of the 1,000 dairy farmers that were surveyed in February-March's National Dairy Farmer Survey were re-interviewed to update their intentions and attitudes.
- 78% of respondents were fairly-to-very positive about the future of the national industry - up from 72%.
- The proportion of respondents who feel very positive remained at 9%, but the proportion very negative has fallen from 6% to just 2%.
- Confidence in the national industry had improved among respondents in all regions except NSW.

Figure 3- Positive attitude to national industry



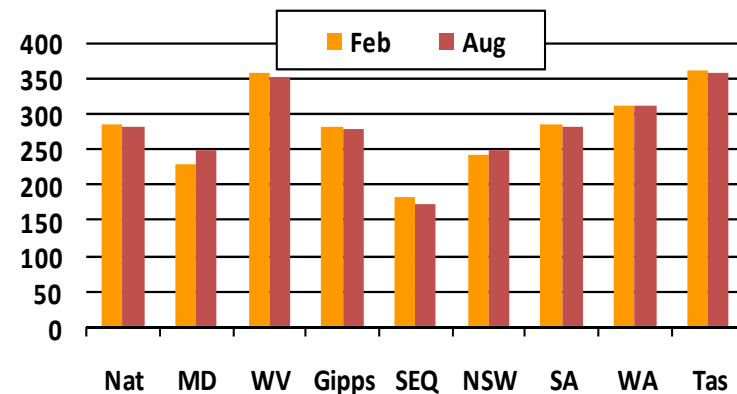
- The average volume of milk produced by respondents during 2010/11 was around 3% lower than anticipated in February/March.

Figure 4 - Average herd production 2010/11 (million litres)



- While back in February-March respondents predicted their herds would average 285 milking cows, this forecast has been revised down slightly to 282 cows. This is line with the number of cows milked by this group in 2010/11 (281).
- Some 60% of respondents anticipate their herd numbers to remain the same as predicted in March, 25% expect a smaller herd size and 14% a larger herd.

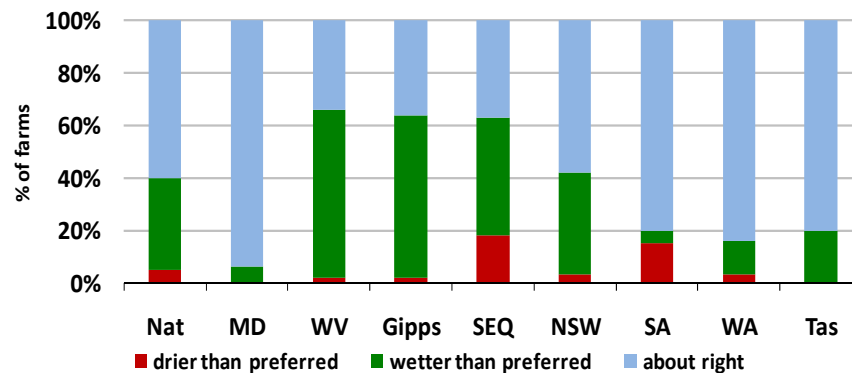
Figure 5 - Average herd size expected 2011/12



# August farmer survey

- Central NSW is the only region where a slightly higher proportion of respondents (23%) expect to milk more cows over the next 12 months, compared with 18% expecting a smaller herd size.
- The main reasons for milking fewer cows than was planned in February-March were: poor seasonal conditions (23%), higher rates of cow culls (20%) and losses (20%) as well as lower in-calf rates (19%).
- 60% of respondents described the seasonal conditions currently being experienced on farm as 'about what they would like it to be'. 35% said it is a wetter than preferred (mainly in southern Victoria), while 5% said it is too dry (mainly in Queensland).

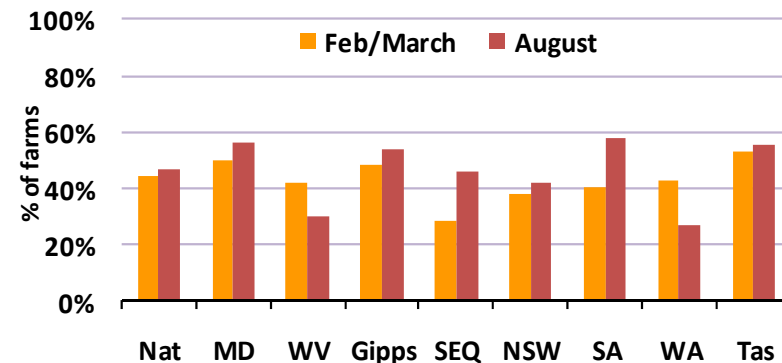
**Figure 6 - Seasonal conditions currently experienced**



- With the majority of respondents, experiencing favourable seasonal conditions, just 24% are planning to change an aspect of their farming systems. These will mainly be in the area of feed systems (11% of all respondents) and calving systems (8%).
- 7% plan to build a feed pad, and 4% intend moving to a lower input cost feed system. 3% plan to adjust the timing of their calving, mainly to spring or summer. Two thirds of farmers contemplating a change to their production system will seek advice to do so, mostly from private consultants.

- The greatest challenges farmers identified over the next six months included seasonal conditions - nominated by 20% of respondents -, milk price (18%), and cost of inputs including electricity and fuel (10%).
- Looking further ahead, expectations for growth have changed little since the earlier survey – at least nationally. By 2013/14, 47% of re-surveyed farmers expect herd production will be greater than 2010/11, slightly more than they had forecast in February-March (44%). However, there were more significant regional shifts with fewer farmers expecting to increase production in western Victoria and Western Australia than previously, while more farmers were contemplating growth in south-east Queensland and South Australia.

**Figure 7 - Expecting production to increase by 2013-14**

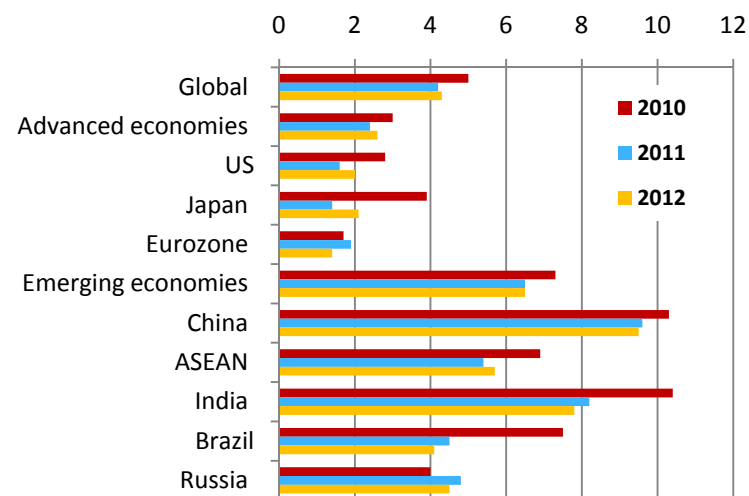


- The key reasons supporting greater herd production by 2013/14 include increasing cow numbers (32%), improved home-grown feed availability (23%) and genetic improvements in their herds (12%).
- Most of the 44% of respondents expecting to produce about the same in three years time felt the farms were already running at capacity (34%) or had low motivation (17%).
- Respondents expecting to produce less in three years time 3% mostly cited unstable or unfavourable milk prices as the driver for reducing their output in three years time.

# Global economy

- World financial markets are in turmoil amid renewed concerns that both the fragile **US economy and a debt-ridden Eurozone could plunge into a new recession**, just three years after the last one.
- A combination of high oil and commodity prices, turmoil in the Middle East, Japan's earthquake and tsunami and Eurozone debt crises have shaken the financial sector and forced governments to cut spending. In the US fiscal problems and a Standard & Poors country credit rating downgrade have led to increased sensitivity to risk.
- The IMF recently cut its forecast for US 2011 growth to 1.6 percent from a 2.5 percent forecast made in June.
- In the first half of 2011, US GDP grew by an annual average rate of less than 1%, which demonstrates **the brittle US recovery**, despite ongoing fiscal stimulus.
- The IMF has warned governments not to slash spending to avoid sparking a new recession and stalling the feeble economic recovery from the 2008 crisis.
- Europe's insufficient response to the sovereign crisis and the events around lifting the US debt ceiling have negatively impacted the financial markets, and substantially eroded business and consumer confidence.
- **The European Central Bank (ECB) has been buying government bonds** of financially stricken countries to try to halt the spread of Euro zone debt. This can only be a temporary measure since Italian and Spanish debt is larger than the ECB's total balance sheet.
- Europe's past rate hikes, the sovereign crisis and the fiscal policy tightening will take a toll on its growth. The euro area GDP is likely to stagnate later this year and in early 2012.
- Given that Europe and North America are major trading partners of China, a slowdown in these regions will affect Chinese exports and growth, ultimately flowing through into Australian commodity exports.
- **China's central government has been forcing a slowdown of the national economy.** Inflation remains high, mostly due to consumer demand, a stronger currency, higher incomes, and imported inflation from commodities.
- Emerging markets in Asia and South America are insulated from Eurozone fiscal problems, however they remain vulnerable to an economic slowdown in China and to rising inflation.
- After peaking at 7.5% in 2010 **Brazil's economy is expected to slow** to around 3-4 % for the foreseeable future, driven down by the indebtedness of middle-class consumers who fuelled the boom, high taxes and a strong exchange rate. The central bank has now raised interest rates five times this year to 12%.
- Uncertainty remains in the Middle East and North Africa region (MENA) following revolutions and conflict in Egypt, Tunisia and Libya in the first half of 2011. If social unrest spreads to larger oil producers, this would result in a renewed spike in world oil prices and heightened inflationary pressures.

Fig 8 - Global GDP growth outlook

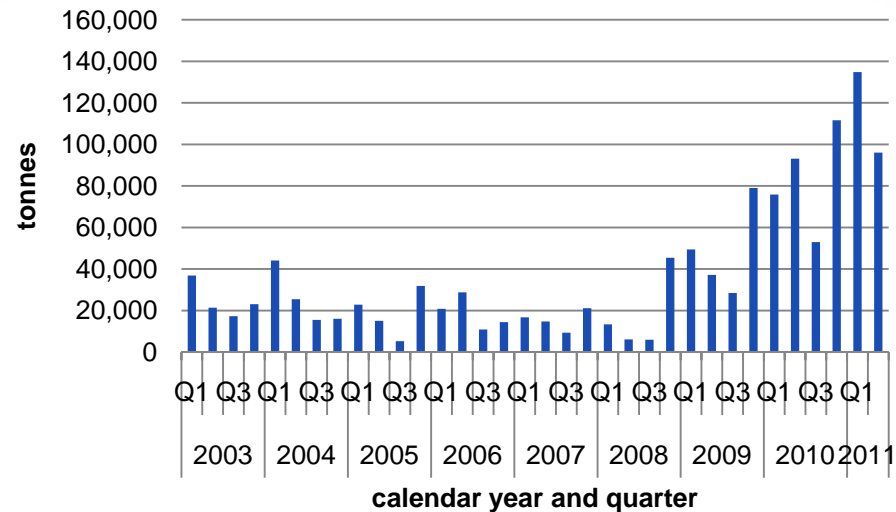


Source: IMF

# Global demand

- **Recent economic events** have shaken global dairy markets, but **are yet to extinguish demand growth.**
- Global dairy exports for the first half of 2011 are up 19% (almost 780,000t ) on 2010. Key growth categories are whey, skim and whole milk powders (up 30%), while cheese and butter trade also increased 20%.
- **China** remains the **primary driver** behind global whole milk powder (WMP) markets. Imports have slowed in recent months, however, we are not concerned yet as the **reduced import volumes came off a very high demand period in prior months, and reflect a seasonal slowdown.**
- Further reductions to Chinese tariffs for imports from NZ (due to the NZ-China FTA) in 2012 are expected to encourage demand for NZ powder as buyers take advantage of discounted quota volumes.
- Anecdotal evidence from major users of Australian dairy ingredients in Asia suggests that **most opportunities for reformulation** to replace dairy with cheaper substitutes **have been taken during the 2007/08 price spike.**
- However, **companies are reducing pack sizes** and using non-dairy ingredients in new (lower-priced) products developed for price sensitive markets.
- Global **demand** has also been **supported** by a **temporary increase in import demand** from Korea, Japan and India to meet short term domestic requirements
- Dairy **exports to the Middle East, region are up 28%** (134,000t) for the first half of 2011 compared to the same period in 2010. Volume growth has been in milk powders and butter.
- **Russian butter production is down 8%** for the year to August, compared to the same time last year. Imported butter now represents around 25% of total Russian butter sales.

Fig 9: China Qtlly WMP Imports (tonnes)



- **Hot summer** conditions in the northern hemisphere have **increased ice-cream consumption** and reduced the volume of milk available for butter.
- **US and European butter stocks** are **at comfortable levels** for this time of year, but may not increase as the festive season approaches, and sales increase.
- **High retail prices are meeting resistance from US consumers** after paying more for dairy all year – but not by as much as initially thought. Consumption is expected to recover as the festive season approaches.
- US food service, particularly fast food chains are coping well in the face of tough economic conditions and higher input prices. Average same store sales for some burger chains are up 4% on last year.
- The recent drop in US wholesale cheese prices has **increased international buyer interest in US cheese.**

# Substitute products

## Vegetable oils

- A strong recovery in palm oil production, increased supply and lowered palm oil prices from February this year. Global butterfat prices have also eased in the last two months, reducing the premium paid for butterfat compared to palm oil.
- Despite improved palm oil availability, vegetable oil production is expected to continue struggling to keep pace with demand growth over the next 12 months.
- There is a mixed outlook for vegetable oils, with growing availability of palm and sunflower oil, while supplies of rapeseed and soya oil decline.
- While supply is tightening, consumption growth has moderated slightly as some **demand has been burnt-off by higher prices**.
- **Elevated crude oil and biofuel prices are expected to maintain upward pressure on global vegetable oil markets, but substitution remains a risk.**

## Soy protein

- **World soybean production is expected to grow marginally in 2011/12.** Reduced soy plantings in the Northern Hemisphere means that growing demand is increasingly reliant on supply growth in South America.
- A temporary lull in soybean demand from China has allowed record stocks to build in South America. Supply from South America will be plentiful until at least the beginning of 2012.
- World soybean stocks (at end of August) are estimated to be 74.5m tonnes, up almost 9m tonnes from one year ago
- Consequently, **soy protein will remain significantly cheaper compared to dairy, increasing the likelihood of substitution for price sensitive applications.**

Fig 10 - Butterfat price premium vs palm oil (US\$ per kg fat)

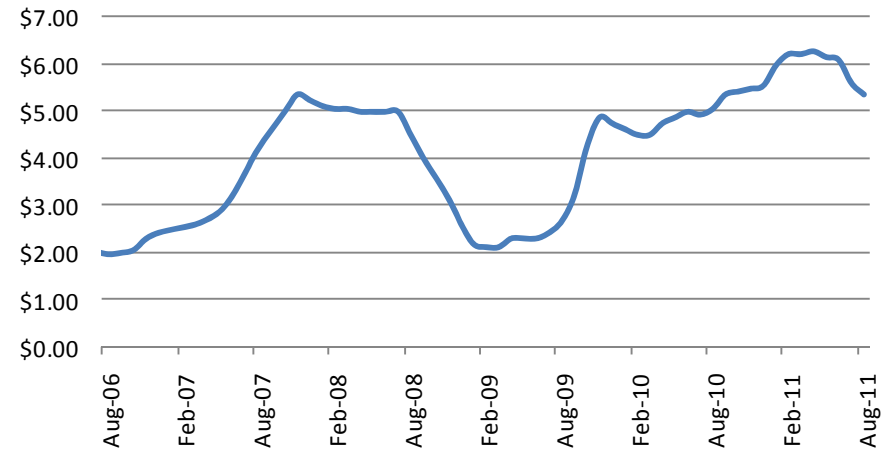
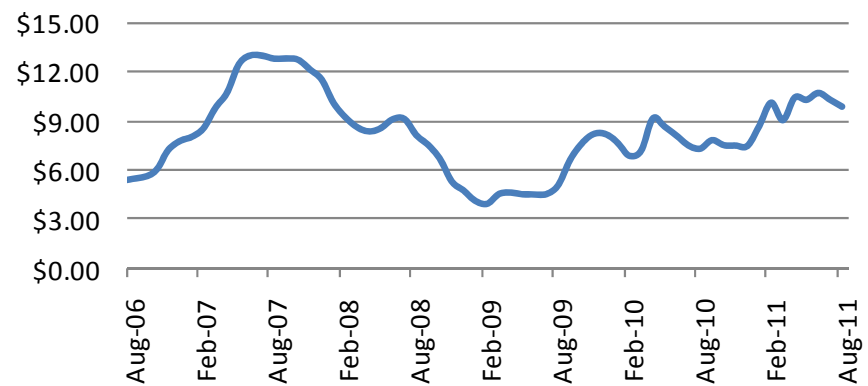


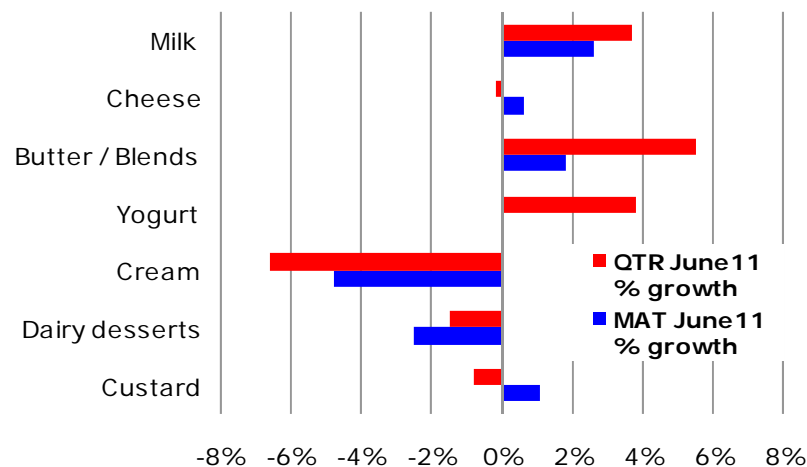
Fig 11 - Dairy protein price premium vs soy meal (US\$/kg protein)



# Australian market

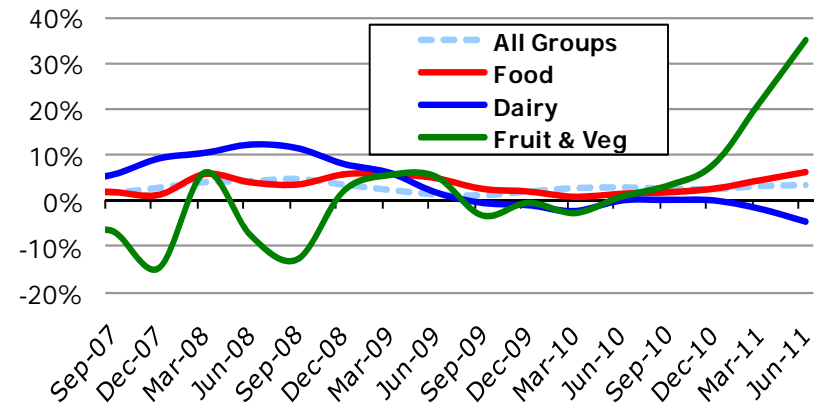
- Against a background of growing economic uncertainty, the Australian dairy market has performed well for the quarter to June. **Domestic sales volumes have lifted for the key milk, butter and yogurt categories** during the June quarter – compared to annual trends.
- At the same time, **wholesale prices have lifted** across all product categories – with the exception of drinking milk.
- **Milk sales through the grocery channel which - includes major supermarkets - have continued to rise** in the last quarter – up 6.7% - as continued supermarket discounting of private label products encourage supermarket milk purchases. However sales through non-grocery channels, such as convenience stores and foodservice outlets have fallen by 3.1% - indicating a **significant shift in milk sales to the supermarket channel**.

**Fig 12 - Domestic sales by dairy category**  
(% volume change on LY)



- **Consumer confidence fell 3.5%** in August – **down for the fourth consecutive month to two-year lows** – **on rising concerns** about the global economy; recent share market volatility, uncertainty over the direction of interest rates; a softening in house prices; the carbon tax and job losses in a number of sectors.
- **Households remain cautious** – with the **Australian household savings rate now at 11.5%** which represents a more traditional savings pattern. However despite soft retail sales, expenditure on **overseas travel has increased significantly**.
- **ABS retail sales are generally sluggish**, recording **easing growth in the foodservice sector**. Cafes and restaurants are up 3% and takeaways unchanged in Jan-June11 – down from 7% and 3% growth respectively over the year. This compares with **4% growth for supermarkets** – up from 3% over the year.
- **CPI-measured food inflation jumped to 6.1% for 2010/11**, driven by flood and cyclone impacts on food production in early-2011. Within the food category, **dairy was down 4.6%**, while **fruit and vegetable prices were up 35.2%**.

**Fig 13 - CPI average prices (% change on LY)**

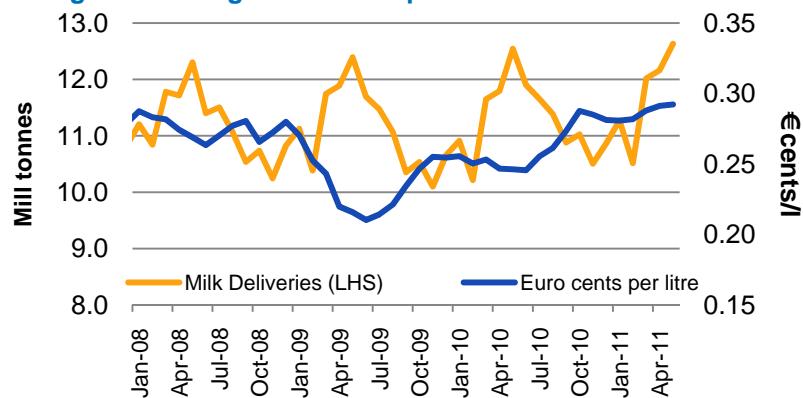


# Global supply

## Europe

- **EU milk deliveries in the first half of 2011 were up 2% on the same period in 2010.** A warm May and June hindered, but a cooler July improved production.
- The contribution to growth varied, with western countries generally having higher outputs and eastern countries lower. The biggest producers Germany and France were ahead of the previous season. Germany produced 14.65bn litres putting it ahead 2.4% on the previous year.
- Ireland was in danger of exceeding its country quota and was up 11.8% for the year. UK, Austria and Latvia were performing well, in contrast to Bulgaria, Hungary and Romania.
- **Milk prices remained higher than in the first half of 2010.** Looking at June 2011 (in AUD terms), Italy (54cpl) commanded one of the highest farm-gate prices. The UK's price (41cpl) - although higher than last year - still lags behind the 'Weighted EU Average' (47cpl).
- EU supply will be impacted by increased costs. Consequently, milk deliveries are expected to slow, with input increasing 1 to 2% in 2011.

Fig 14 - Average EU 27 milk price and milk deliveries

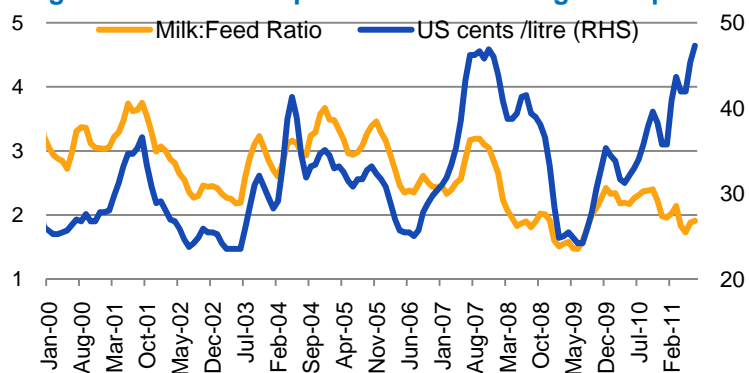


Source: EU Commission

## United States

- **US milk production has been slowing over the past 10 months,** increasing only 0.7% in July. For the year to July, 50.82bn litres had been produced, up 1.56% on 2010.
- Herds grew by 7,000 head in July to 9.215 million, up 80,000 head on last year. However in July milk yields per cow fell 0.17% below July last year.
- Key factors affecting milk yields have been extreme heat (Midwest and Northeast) and Hurricane Irene, impacting Vermont (1% of production at July 2011) and upstate New York (7% of production at July 2011) suffering flooded fields and roads leading to milk dumping. Price of grain and other inputs will also factor in production decisions.
- **The forecast for 2011 U.S. milk production has reduced to 86.14bn litres, however this still represents a 1.46% increase from 2010 (84.91bn litres).**
- The recently released Bain report found that although global buyers view the U.S. as a strong source of future supply, more favourable U.S. policies are vital in order for the U.S. to be regarded as a consistent global supply source.

Fig 15 - US milk:feed price ratio and average milk price



Source: USDA

# Global supply

## Australia

- Australia's milk production **finished the season up 1%** at **9.1 billion litres** – with the last five months in positive territory.
- As was the case at this time last season, **strong opening farmgate prices** from exporting companies competing for milk, **plenty of rainfall** across south-eastern Australia, the **best early-season irrigation allocations** in years, and stable grain prices, all suggest that **the local industry will start the new season on a positive and potentially profitable note.**
- ABS herd size data indicates **higher numbers of heifers at June last year**, suggesting some **herd rebuilding may occur** this year.
- **DA's current forecast milk production remains for growth of around 1.5% to 9.25 billion litres** for 2011/12 - with both upside and downside risks around the country.
- **Conditions are too wet across much of southern Australia at the moment which** is making production difficult, and potentially causing pasture damage. The soil moisture profile **should see strong pasture growth when temperatures begin to warm up.**

## New Zealand

- Milk production in the 2010/11 season (ending May) was 5.2% above last year.
- The surprise **snow storm** affecting many areas in both the north and south islands **disrupted milk collections for a short period**, but is not expected to have an overall impact on this year's milk flow.
- Favourable conditions in the early parts of the current season suggest **NZ milk production could grow by up to 8% this season.** Milk solids growth for the first two months is already up almost 10%. This growth projection is supported by good pastures and dairy cows generally being in good condition.
- Should this rate of increase be maintained it would significantly impact market balance.

## South America

- Milk production in Argentina has been very strong, increasing 3.5% in July (vs. July 2010), and almost **16% ahead for year to date** production compared to last year.
- Milk powder production in Argentina is at capacity, suggesting strong WMP availability on export markets. **Excess milk will flow into cheese production, while some will be absorbed within the region, product is also likely to be sold on the wider market.**
- **Brazilian milk production is forecast to grow a comparatively modest 3%**, and while production in Uruguay is up significantly, Chile has had more moderate growth.

## China

- The dairy industry is still struggling in the aftermath of its 2008 melamine crisis. The government is stepping in to control recent episodes of animal disease and milk contamination.
- **Milk production is expected to grow at 3.3% annually on average.** With this milk destined for drinking milk, even with production growth, China is likely to rely on imports to meet demand.
- Increased dairy consumption is driven by an escalating middle class, rising household incomes, especially outside the big cities, greater health consciousness, and more retail outlets.

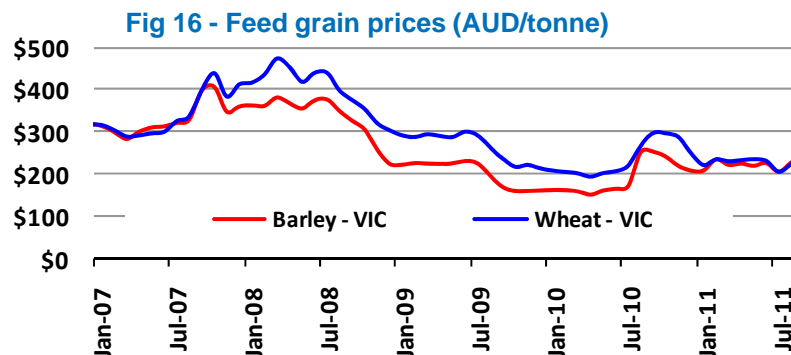
## India

- In 2009-10 India produced around 109bn litres of milk. **Production in 2011 is forecast to increase to a record 118bn litres** due to a good monsoon season, better management, improved cattle genetics and good feed/fodder availability.
- Consumption of milk is expected to increase by a higher rate than production due to higher disposable incomes particularly in rural areas, increased demand for value added milk products in cities, and traditional usage of liquid milk as a key source of protein.

# Inputs

## Feed grains

- ABARE's June Crop report estimated that the total winter crop will dip to 40.8m tonnes – on larger plantings but lower yields than last year's record highs. **Wheat crop forecasts range from 21.8 to 26.2m tonnes**, similar to last year; while the **barley crop** is expected to be around **8.1m tonnes**.
- **Winter crop conditions started very well on the east coast** with good subsoil moisture profiles. **Below average winter rainfall has been relieved by widespread rains during August lifting crop prospects** in SA, northern Victoria and southern NSW. However, northern NSW and southern Queensland are shaping up as 'problem areas' reducing crop forecasts. **A dry start for the WA crop has been offset by July rains** - although regular spring rainfall will be required in the west due to dry subsoils.
- ABS data to end-July11 reports **5.3m tonnes of feed wheat** in bulk grain handler storage compared to 0.9m tonnes last year. The east coast's **feed wheat stocks won't return to normal levels** of around 1m tonnes **for another year** – assuming an 'average' harvest and continuing demand from the Asian livestock sector.
- **Local feed wheat prices** have remained fairly stable over recent months; with Melbourne-delivered **feed wheat around \$225 /tonne** and **barley around the \$220 /tonne price**.



- International buyers have become **much more comfortable about world wheat stocks** with significantly **improved weather conditions** in the last two months in the northern hemisphere producing countries accounting for **90% of world production**.
- As a result, **international prices have eased considerably over the last quarter** as northern hemisphere supply fundamentals; and renewed economic uncertainties reduced speculation in soft commodities. However, **higher quality wheat is in short supply**.
- **The US corn crop** – nearly 40% of world production in 2010/11 – looks to **pass a 'tipping point'** this year as more corn will be used in the production of ethanol (38%) than used as stock feed (37%) – with the balance used in industrial food use (11%) and exports (14%).
- US corn remains **the biggest swing factor** in the global grains market as **US stocks are historically very low** – and **corn is the basis of animal feed rations** in the US and import-dependent Asia.
- **Corn prices remain very strong** – due to reduced harvest areas and high temperature-induced lower yields in the current US crop .
- **More Australian feed wheat may be exported** into traditional corn markets – **but plentiful local stocks, new crop supply conditions and a strong AUD will likely keep a lid on local prices**.

## Hay

- **Demand for fodder is lifting** across south-eastern states as **continued wet conditions inhibit grazing** and threaten pastures in southern Victoria and South Australia. While winter rainfall was around average in the coastal south, **the soil profile was already saturated in the autumn**.
- While hay is selling in the south-east of the country, **prices remain soft** as sellers are keen to move stock and reduce carryover ahead of this year's harvest.

# Inputs

## Fertiliser

- Rabobank reports that **global fertiliser prices have begun to ease in recent weeks - after global benchmark prices have reached close to double the levels of last year** due to supply shortfalls, high energy and raw material prices, and brisk demand.
- Higher global prices are flowing through to local farmers, **but being moderated by low inbound freight rates and the strong currency.**
- Xcheque's **Dairy Fertiliser Mix** has risen from 116% to 140% of the June 2006 benchmark in AUD terms over the last quarter.
- Despite the rise in **N** during the second quarter of 2011, **the outlook remains weak** - consistent with softening oil prices and the general gloom about the European and US economies. **Relatively stable prices for N and P are forecast for the last quarter of 2011 followed by significant falls in early-2012** - reflecting the seasonality of demand in the northern hemisphere.
- **Potash (K) suppliers are attempting to push prices strongly** - after making significant gains in recent major Indian supply contracts.
- Relative to historical benchmarks, **Australian fertiliser prices are at the low end of expectations given international prices** and the current exchange rate. Price rises are expected in the short term, especially for DAP and potash. The only bright spot on the horizon may be a benefit from the projected weakness in nitrogen prices during early-2012.

Fig 17 - Indicative fertiliser prices (AUD /t)

	March	July	Dec11 forecast
Urea	540	600	650-700
DAP	770	770	850-900
Single super	325	325	325-375
Potash	640	640	650-700

Source: Xcheque

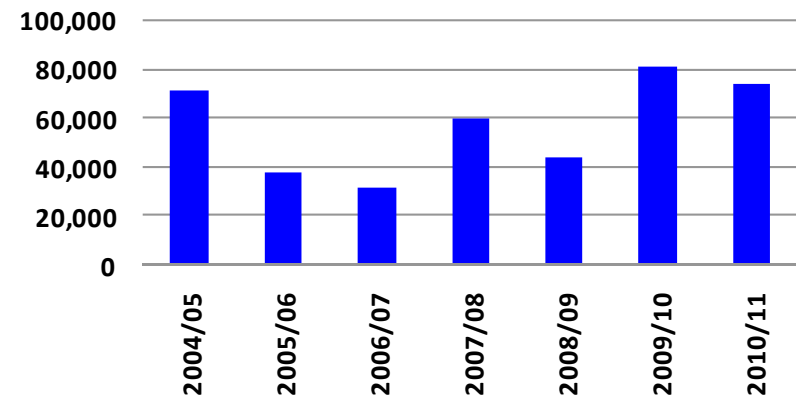
## Water

- **Continuing rainfall over wet catchments** since mid-2010 has **further improved water storage levels** in the Goulburn-Murray system and all northern Victorian **systems have received an allocation at the opening announcement on 1-July** for the first time since 2002/03.
- The main **Goulburn system is already at 87% allocation and the Murray system at 61%** - with both to be at 100% in coming months.
- **Temporary water prices are as low as \$20 to \$25 per megalitre.**
- The majority of **Bureau of Meteorology climate models forecast that neutral conditions** are likely to continue through the southern spring. However, Japanese forecasters say that **La Nina conditions are returning** until early-2012.

## Cows

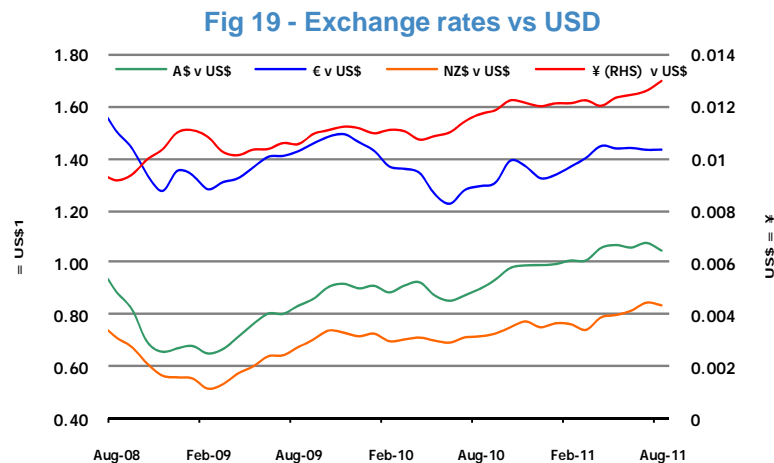
- **Cull cow sales were down 7% over 2010/11** - and **down 16% on the 8-year average** - as farmers retained cattle where possible to take advantage of relatively strong milk prices and improved seasonal conditions around most of the country.
- **Live dairy cattle exports eased 9% to 73,800** in the twelve months to June11- with the decline spread evenly across both halves of the season.

Fig 18 - Dairy cattle export volumes



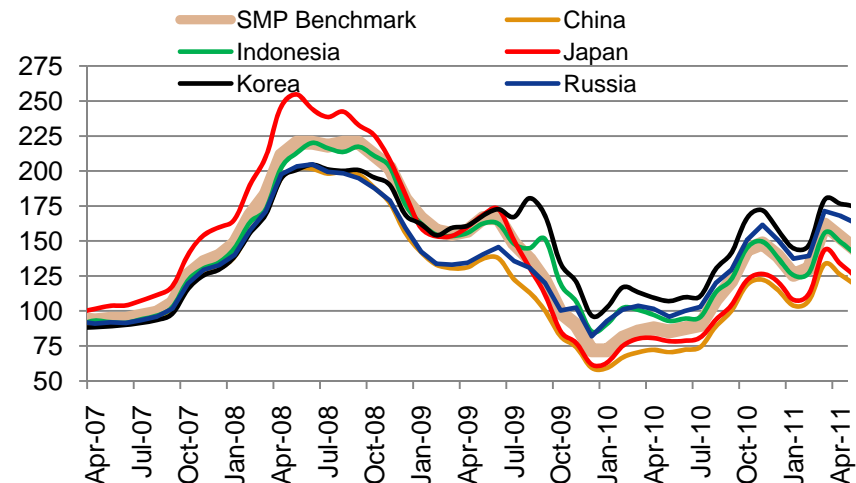
# Exchange rates

- The structural shift to emerging markets continues, with currencies rising against the US dollar as **Asian countries are engaged in a fight against inflation**. The weakness of the US recovery has resulted in the Federal Reserve postponing any rise in US interest rates for 2 years, which will result in a weaker US dollar. The recent Standard & Poor's downgrade of the US economy indicates **the US dollar is less of a safe haven than it was in 2008**
- While advanced economies need a weaker currency and better trade balance to restore growth and boost recovery, they can't depreciate their currencies simultaneously. Relying on exchange rates to influence trade balances could mean that "currency wars" are on the horizon, with Japan and Switzerland moving to weaken their exchange rates. While the RBA has ruled out this option, others could soon follow.
- **The relatively high level of interest rates in Australia** is in stark contrast to many other developed economies, and this draws in more funds, supporting a stronger currency.
- Sovereign debt issues in the US and Eurozone are expected to accelerate moves away from developed markets in favour of emerging markets to manage risk.



- The weakness in US and European economies has resulted in an extremely strong capital flow into Asian, Russian, Latin American and even African economies, thus strengthening the demand for worldwide commodities.
- **The euro has remained strong this year** as investors concentrate on the Eurozone's favourable yield differential and ignore an unresolved debt crisis. A stronger Euro implies Europeans will be less competitive in dairy export markets.
- **The Japanese yen has remain steady against USD** this year maintaining purchasing power for Japanese importers.
- The big four Australian banks have a **forecast range for the AUD of 85-105 US cents by the end of this year**. This is in line with a Bloomberg survey of 35 financial institutions produces a range for the AUD of between 85 and 108 US cents by the end of this year.
- Despite higher commodity prices, **import affordability has improved, particularly for SMP, as the currencies of most importing countries have strengthened against the USD**.

**Fig 20 - Import affordability index**  
Feb 2005 = 100



## DPIV farm monitor analysis – Balancing return on equity & risk

- The Department of Primary Industries Victoria (DPIV) Dairy Industry Farm Monitor Project (DIFMP) provides a financial and comparative analysis of 74 dairy farms from across three regions, Northern Victoria, South Western Victoria and Gippsland.
- The project, a joint initiative between DPIV and Dairy Australia, aims to provide DPIV and the dairy industry with farm level data relating to profitability and farm performance, as well as identify the key drivers of profitability and production growth.
- For this Situation & Outlook Update, **DPIV analysts have used the results of the 2010/11 study to comment on the influence of equity levels on farm profitability and return on equity.**
- Table one summarises some key physical and financial data from the monitor farms. Further detailed farm financial and physical performance data can be found at [www.dpi.vic.gov.au/dairyfarmmonitor](http://www.dpi.vic.gov.au/dairyfarmmonitor).

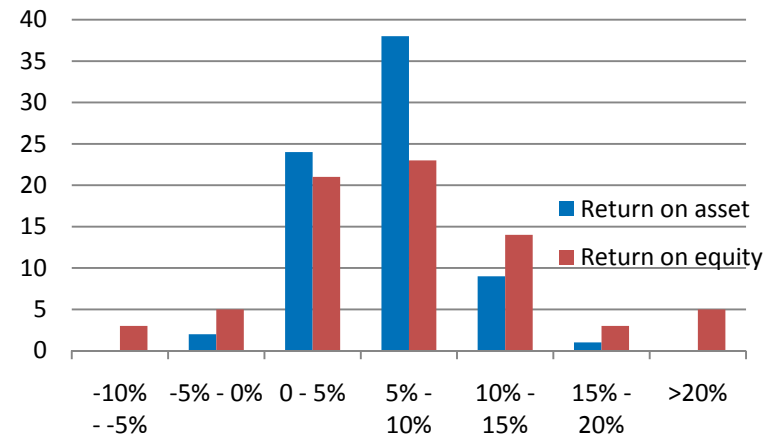
**Fig 21- Key physical and financial results for DPIV Dairy Industry Farm Monitor farms 2010/11**

	State	North	South West	Gippsland
No of farms	74	24	25	25
Herd size	305	261	369	285
Milk solids (kg MS/cow)	493	495	491	494
Milk price (\$/kg MS)	\$5.64	\$5.69	\$5.62	\$5.59
EBIT per ha	\$1,260	\$1,172	\$1,022	\$1,582
Equity %	68	66	65	74

### Owner equity, return on equity and risk

- When comparing farm performance, the financial measures of earnings before interest and tax (EBIT) and return on total assets managed are unaffected by the financial structure of the business, i.e. the owners equity.
- However, when comparing EBIT after interest which is net profit, or returns to owners' equity, the amount of debt and interest or lease costs paid determines the return to owner equity. This is highlighted in figure 22 below, where the greater distribution of return on equity compared to return on asset is displayed. This article discusses how differing levels of owner equity affect the measure of return on equity and growth.

**Fig 22 - Distribution of farm by return on assets and return on equity**

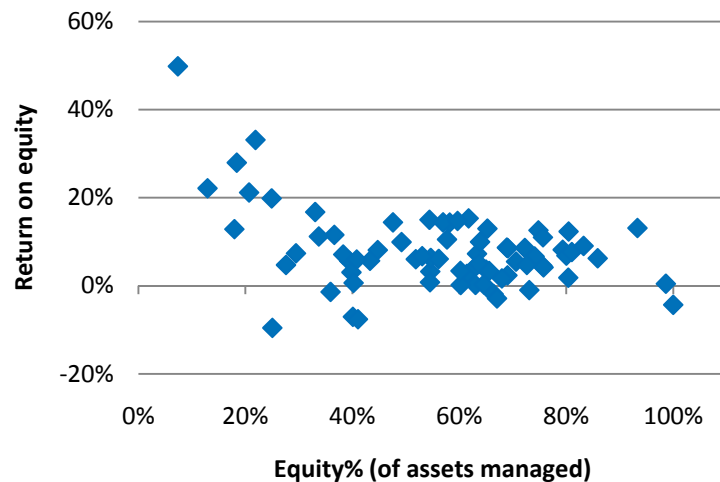


- 2010/11 has seen strong milk prices and the best incomes to farmers since 2007-08. The average return on asset for farmers was 6.2%, while average returns on equity were 7.8%. The average return on equity asset for farmers in the top 25%, ranked by EBIT per hectare, was 9.5% while return on equity for this group was 12.7%. The range across the entire sample for return on asset and equity was -4.3% to 16.4% and -9.6% to 49.8% respectively.

# DPIV farm monitor analysis – Balancing return on equity & risk

- Despite the return on equity levels appearing to be very good, especially those greater than 20%, they do need to be viewed with some caution. As can be seen in figure 23 below, the five farms which recorded returns on equity greater than 20% each own less than 25% of the assets they manage. This means they have high debt or lease costs, and are more exposed to the principle of increasing risk.

**Fig 23 - Equity percentage (of assets managed) versus return on equity**



- The principle of increasing risk means that farms that have low equity (also called highly geared) will grow their equity faster in periods when returns on assets, higher than the interest rate, are made, than those farms with less debt and higher equity. However, when low returns on assets or losses are recorded, such as in 2009/10 in northern Victoria, those farms with high debt and low equity erode that equity at an even faster rate than the rate at which they grow in the good times.

**Fig 24 - Principle of increasing risk - example**

	<b>Profit made (\$000) 10% return on asset</b>		<b>Loss made (\$000) -10% return on asset</b>	
	<b>Farm 1</b>	<b>Farm 2</b>	<b>Farm 1</b>	<b>Farm 2</b>
<b>Business structure</b>				
Total assets managed	\$4,000	\$4,000	\$4,000	\$4,000
Debt or assets leased		\$2,000		\$2,000
Equity	\$4,000	\$2,000	\$4,000	\$2,000
% of equity in total assets	100%	50%	100%	50%
<b>Business returns</b>				
EBIT	\$400	\$400	-\$400	-\$400
Return on Assets	10%	10%	-10%	-10%
Interest rate on debts/leases	8%	8%	8%	8%
Interest & lease costs	-	\$160	-	\$160
Net profit	\$400	\$240	-\$400	-\$560
Return on Equity	10%	12%	-10%	-28%

## DPIV farm monitor analysis – Balancing return on equity & risk

- The previous example highlights that if two farms in a good year make the same return on assets, but one of those farms only owns half the assets then, provided the rate of return is higher than the cost of accessing the additional capital, they will grow their wealth more quickly than a farm that owns all of the assets.
- Conversely, if both farms make a loss of -10% return on assets then the farm with only 50% equity will lose a far greater proportion of their wealth than the farm with 100% equity.
- In the example, farm two is more exposed to risk. In good years this exposure means that the overall wealth of that business will grow at a faster rate than farm one, however in bad years their equity will fall more quickly than farm one and at an even faster rate than they were able to grow it when things went well.
- The take home message is that some exposure to risk will enable farmers to grow their wealth more quickly than they otherwise would in the good years. However if they are over-exposed to debt, in bad years their losses will be even greater. The key to successful farm management is to balance levels of exposure to enable wealth to grow, but also to ensure the long term viability of the business is not jeopardised.