



Dairy 2009

Situation and Outlook

Summary Report

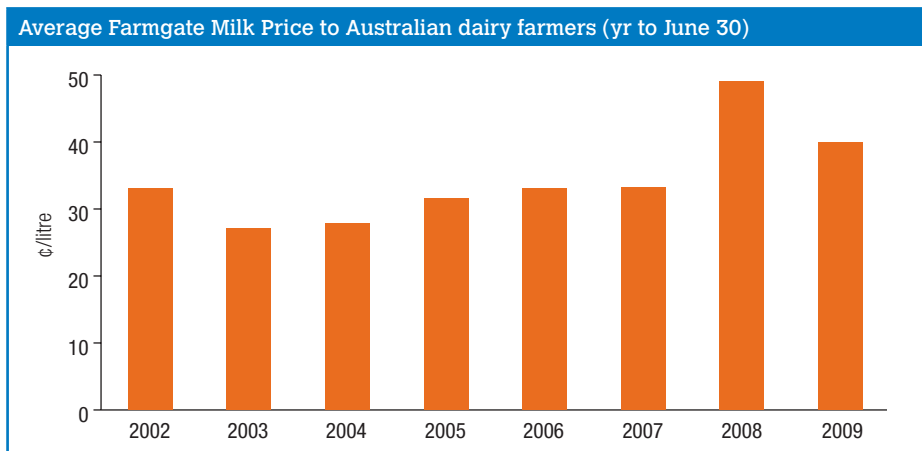
The industry in 2009



- Unprecedented volatility in the international market associated with the global financial crisis and resultant economic downturn, has had a severe impact on farmer confidence as well as finances.
- Falling commodity prices translated rapidly into lower farmgate prices with a 1 in 35 year step-down in milk price announced mid-year across southern dairying regions.
- The financial impact has been severe as many farmers, through climate-related necessity and facilitated by the previous higher farmgate prices, have found themselves locked into production systems with limited cost flexibility.
- Farmers supplying domestically-focussed processors have been insulated from the immediate impact, as supply contracts remain in force. In northern regions, higher milk price has combined with welcome improvements in seasonal conditions, to support higher levels of confidence.
- Milk price has re-emerged as the greatest challenge farmers are facing. The likelihood of a conservative opening price and slow recovery in returns limits the options available in the short term for dealing with adverse seasonal conditions and volatile input costs.
- The medium term outlook remains positive, as population growth, improved incomes in developing countries and likely constraints on production point to higher prices.
- While falling input prices may provide some relief, without a significant improvement in seasonal conditions, particularly in the Murray Darling Basin farmers will face severe difficulty trading through the current downturn.

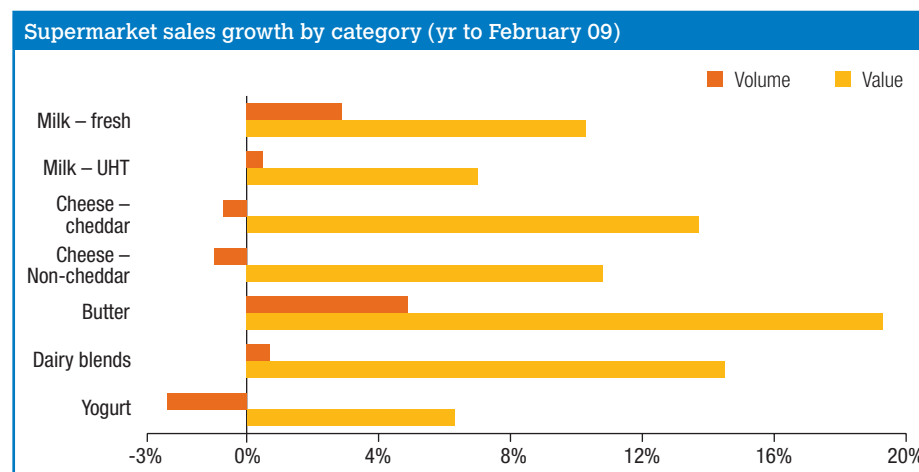
The industry in 2009 *continued*

- Dairy farmers have taken on more debt in recent years to either fund expansion of farm operations, or additional funds for working capital. Balance sheets are now under pressure on many dairy farms as a result of increased liabilities and static or decreasing asset values – including land, cows and irrigation water.
- The ability or willingness of farmers to extend their debt, or to realise the value of their assets, as well as their personal and family commitment to continue dairying are the key factors being weighed up now and over the coming year. The opening price for 2009-10 will be a critical signal for farmers in southern regions. Dairy Australia's forecast range for opening price is between \$3.50 and \$4 per kg MS (24 to 29 cents per litre), implying a full year price range of \$4.00 to 4.60 per kg MS 29 to 34 cent per litre. However, significant uncertainty remains.
- While international commodity prices have stabilised, the appreciation of the Australian dollar has a negative impact, as each 10 cent appreciation reduces farmgate price by approximately 6.5 cents.
- Farmers supplying domestically-focussed milk processors under existing contracts have more certainty regarding milk price in 2009-10. This is reflected in their levels of confidence, as well as their intentions to employ and invest on farm.
- The results of this year's survey indicate that farmers remain largely confident about the future of the industry; however, the short term challenges on farm are significant.



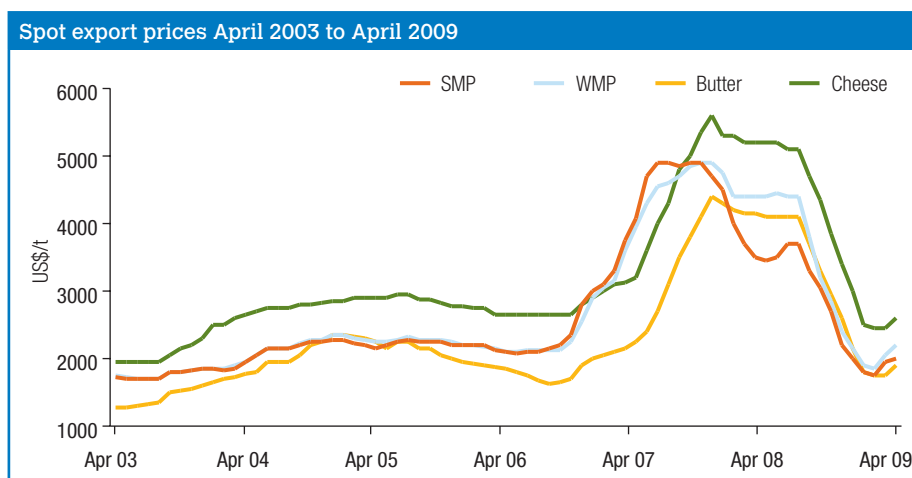
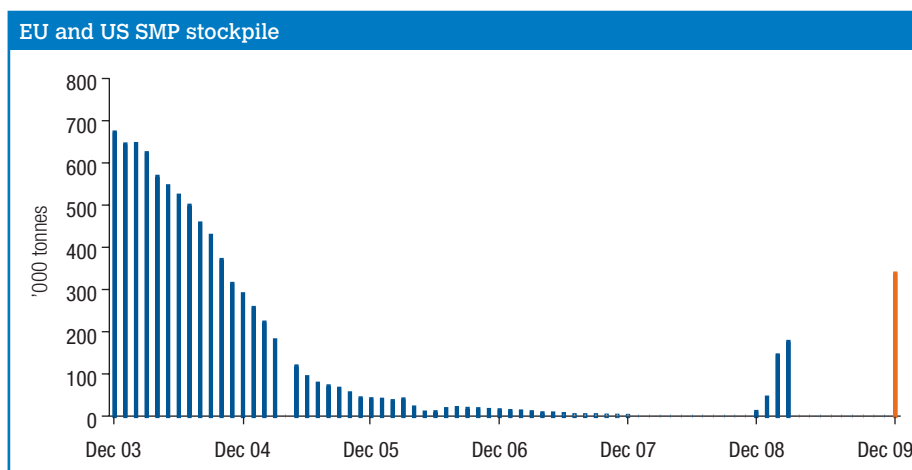
Australian market Situation & Outlook

- In the context of the rapid downturn in export returns, the domestic market has been a bright spot for the industry. Accounting for 55% of annual milk production, the Australian market has offered good value and some volume growth, and underpinned industry returns.
- Higher retail prices have been largely maintained, as supply contracts limit the immediate passing on of lower commodity prices. This has driven category value growth, and volume impacts have been limited as consumers have adjusted to higher prices.
- The full impact of the global economic downturn is yet to be felt in Australia in terms of unemployment. However, lower fuel and interest costs, discounting activity from retailers, as well as the government's fiscal stimulus have actually improved the spending power of many consumers.
- Quick service restaurant sales have been boosted as a result, and cheese consumption is likely to be supported by this trend, as strong growth is being reported in pizza and burger outlets.
- While domestic prices have held, pressure is likely to build on wholesale prices if the downturn worsens, as consumers trade down to lower priced generic products, and contract negotiations reflect the international market situation and the increased focus of manufacturers on domestic opportunities.



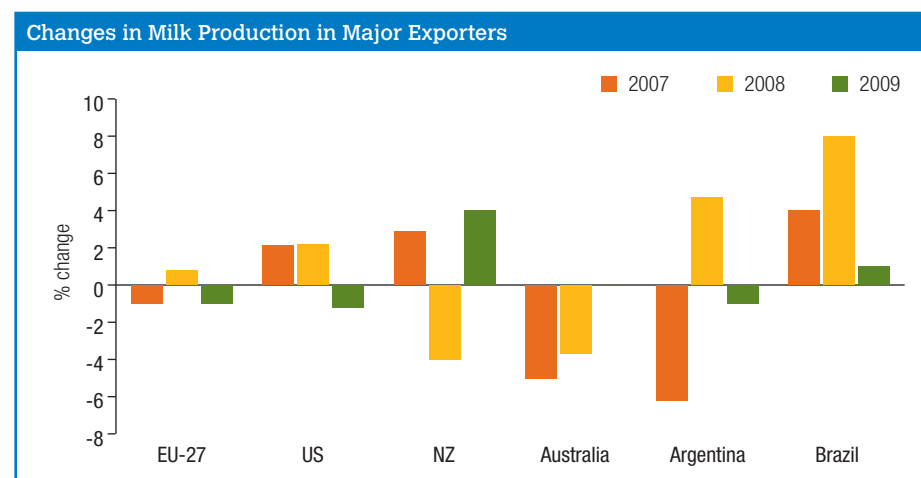
International market Situation & Outlook

- In 2008, after two years of sustained high prices, it seemed the international dairy market had reached a new plateau. However, there were already signs emerging that volatility would be a feature of the market outlook.
- Nevertheless, it would have been difficult to predict the impact of a global financial crisis which rapidly spread from the US to the developed and developing world. Trade in commodities was affected immediately, as insurance and credit markets were impacted by “toxic assets”, bank insolvency fears, and increasingly volatile currency movements.
- Dairy commodity prices immediately went into a downward spiral, as buyers rapidly reacted to initial falls and the increasing financial and economic uncertainty. Supply pipelines were emptied as buyers ceased purchasing, preferring to run down high priced inventories, resulting in a build up of supplier stocks.
- Both the US and then EU governments are intervening in the market – the build up of surplus stocks has triggered the re-activation of export subsidies in Europe and now the US. This has added to the negative sentiment surrounding the international dairy market.
- With buyers re-entering the market to fulfil their immediate requirements, commercial stockpiles for powder in particular have been reduced. Import demand for powders is likely to recover at lower commodity prices. However, the outlook for cheese is less rosy with imports to Japan and Russia, two major cheese markets, constrained by economic conditions and a slow down in EU consumption growth.
- While the international market appears to have bottomed, prices are unlikely to move strongly upwards unless market perceptions alter significantly with a tightening in supply or a surge in demand associated with economic recovery.



World supply

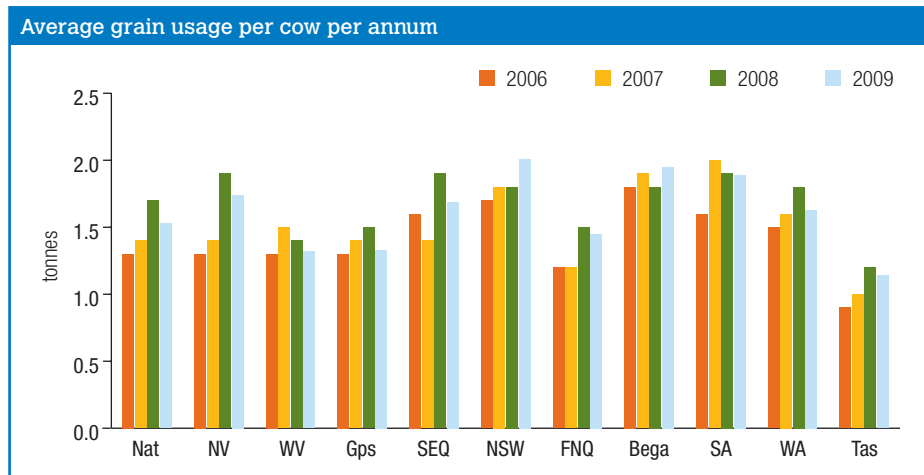
- While world milk supply was expanding through much of 2008, the reversal in economic conditions and dairy commodity prices has been rapidly transmitted to farmers in milk price. In response, farmers have adjusted their production plans.
- Despite a 2% increase in the EU's milk production quota, output is expected to fall by 1% in 2009-10. Despite the Commission's interventions, farmer prices have been cut severely and farmers are responding by reducing production. EU exports are once again receiving subsidies in response to internal lobbying, and in an effort to maintain internal prices, and divert product from intervention stores.
- In the US, production is expected to contract by 1-2% in 2008-09 after growing steadily for a number of years. With milk returns falling more than grain prices, the milk to grain price ratio is at its lowest point on record, thereby discouraging growth.
- In Argentina, severe drought conditions have reduced milk production and will constrain future growth, as the national herd was heavily culled. While the export taxes which have severely hampered Argentina's participation in the world market, are not a factor at present, the low international prices provide little incentive for increased participation.
- In New Zealand, dry conditions in north island regions is hampering milk output. Credit constraints have slowed some conversions on the South Island. Nevertheless NZ production is expected to grow by 4%.



The farm sector in 2009

The National Dairy Farmer Survey results provide the following profile of the industry:

- Surveyed average herd size was 275 cows up from 247 milking cows in 2008, with the inclusion of several large herds in the NSW sample.
- Herds milking 600 or more cows account for 7% of farms, but 25% of national milk output.
- Average milk production per cow was 6,114 litres in this year's survey up from 5,702 litres in 2008.



- An estimated 74% of farmers were operating a system which relied mostly on pasture, with light to moderate feeding of supplements in the bale, while 2% of farms operated a total mixed ration feedlot system. 30% of farms knew what their pasture utilisation was over the last 12 months.
- The average grain fed on surveyed farms was 1.5 tonnes per cow per year in 2009, down from 1.7 tonnes in 2008. 36% of farmers fed more than 1.5 tonnes, down from 42% in 2008.
- On average, 132 ha is set up for irrigation on irrigated dairy farms, however, just 58% of that area was watered during the last 12 months. On average, 51% of the total volume that would be available at 100% allocation was used 2008-09.
- Around 76% of farmers were impacted by a mid-season step down in farmgate price, with the majority reporting it had a major impact on their business.
- Seasonal calving featured on 36% of farms in 2009, compared with 35% in 2008. Split calving characterised 33% of farms, down from 36% in 2008. While year round calving dominates in regions with a high requirement for fresh product supply, it accounts for 32% of farms nationally.
- 28% of farms were staffed solely by the owner or ownership couple in 2009, compared with 34% in 2008 and 43% in 2007.
- 10% of surveyed farms were intending to hire staff over the next 12 months, while 5% of farms planned to lay off staff.

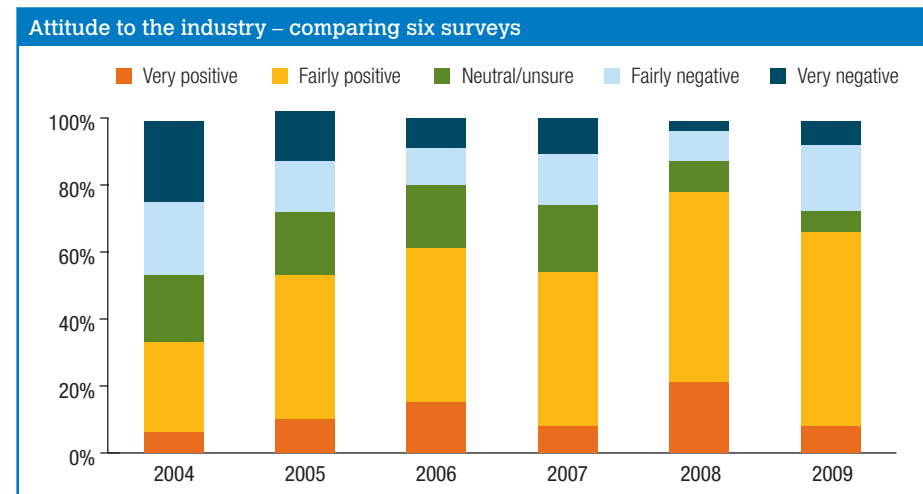
What did farmers say?



The National Dairy Farmer Survey results include the following key findings:

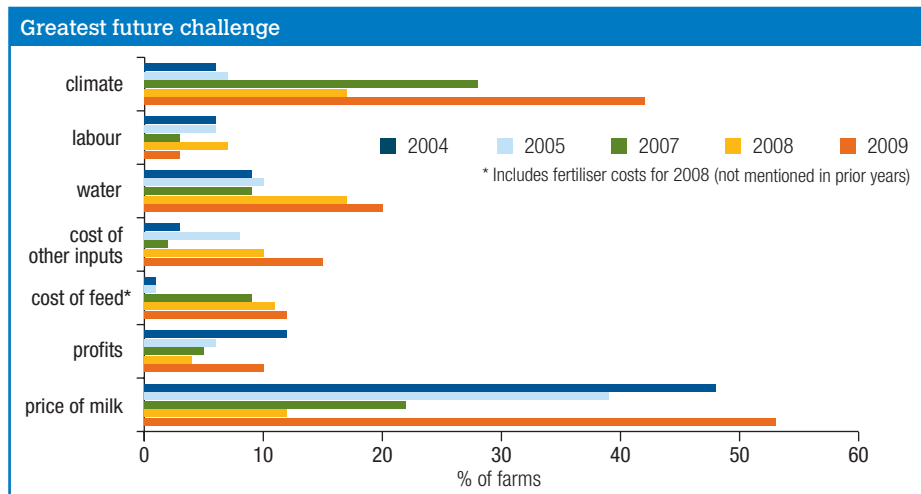
Attitude and Challenges

- 66% of farmers were positive about the future of the industry in 2009 compared to 78% of farmers in 2008. While farmers were less positive than last year, a higher proportion of farmers were optimistic than in all prior years of the survey. Positive sentiment was most often linked to a belief that there would always be demand for dairy products. Low milk price was the most common reason given for negative sentiment.



What did farmers say? *continued*

- The most positive region was south east Queensland and northern New South Wales (81% of farmers positive), reflecting improved seasonal conditions and higher farmgate milk prices. The region has undergone a significant turn around since the survey was first conducted in 2004, and just 32% of farmers were feeling positive about the future.
- Continuing dry conditions and milk price cuts impacted northern Victoria and the Riverina sentiment in 2009, resulting in the lowest proportion of positive farmers (51%).
- Milk price was the greatest current and future challenge mentioned by farmers in 2009, overtaking climate and the availability and cost of inputs. Climate and the cost and availability of irrigation water were the next most often mentioned challenges, both for 2009 and the future.



Investment

- 67% of dairy farmers made on farm capital investments in the previous 12 months, in line with 2008. However, there was a significant increase in the proportion of those investing on farm in both South Australia (79% compared to 67% in 2008) and New South Wales (70% compared to 63% in 2008).
- Machinery remained the largest area of investment, although less dominant than in previous years. Small increases were made in expenditure on milk harvesting and irrigation plant, as well as shedding.
- 32% of farmers were planning on-farm investment over the next 12 months, down significantly from 55% in the 2008 survey. Farmers in far north Queensland, New South Wales and Bega bucked the trend, taking the opportunity offered by improved farmgate milk prices to renew infrastructure.

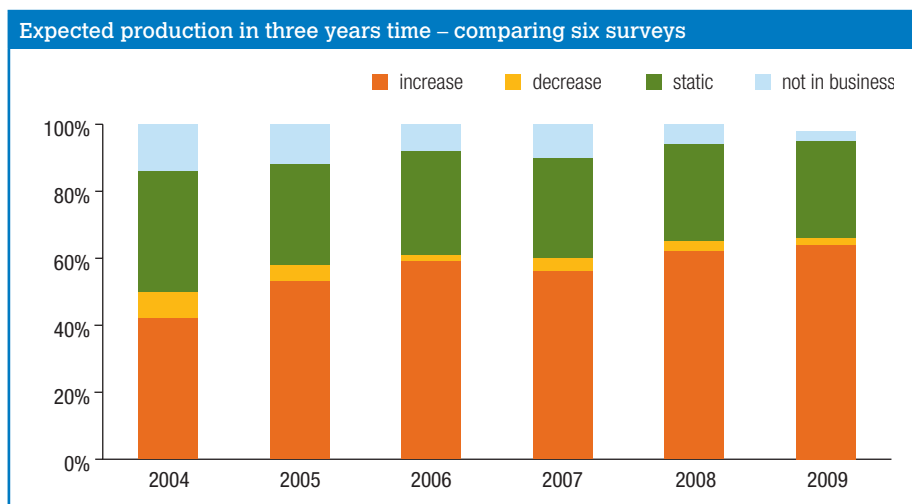
Dairy farm finances

- The Australian Bureau of Agriculture and Resource Economics (ABARE) conducts an annual survey of dairy farmers across Australia. While Dairy Australia's survey canvasses the attitudes and intentions of 1,000 farmers across Australia, the ABARE survey collects detailed financial and physical information from approximately 300 farm businesses. In 2009 estimates for 2008-09 were collected and updated.
- The survey projects a significant fall in farm cash income in 2008-09, reflecting the cut in milk price, with an average of \$74,000 (compared to \$139,500 in 2007-08). At the same time, cash costs are expected to be reduced by 10% due to lower grain and hay costs and interest payments.
- Average farm business profit is estimated to fall from \$74,100 to a loss of \$6,000.
- Analysis by Dairy Australia found increases in farm debt of between 7-9% on the average farm in regions such as Northern Victoria.
- The NDFS indicated that, of the 76% of farmers impacted by the milk price step-downs, 24% have extended their debt and a further 24% have refinanced or deferred their debt to manage their cashflow.
- Equity ratios continue to remain very high for farms across the dairying regions. While debt levels have generally risen steadily since the early 1990s, land values have kept pace, keeping estimated average equity ratios relatively high and constant in the range of 80-85%.
- Analysis by Dairy Australia, based on a range of regional data sources found dairy farm equity levels to be in the range 65-75%. This analysis also showed that debt servicing costs have risen significantly on many dairy farms as dairy farmers have taken on more debt. However, ABARE estimates the capital value of the average dairy farm at \$3.3 million in 2007/08, with equity ratios remaining at a very high 84% on average.
- In the past, rising capital values have kept farm equity levels at a "safe" level (e.g. above 60% equity) and increasing equity has enabled increased borrowing ability for dairy farmers. Balance sheets are now under pressure on many dairy farms as a result of increased liabilities and static or decreasing asset values (including land, cows and irrigation water).

Milk production outlook

- Milk production in 2008-09 has been constrained by reduced cow numbers and unfavourable climatic conditions, as well the mid-season milk price cut, which prompted many farmers to reduce both herd numbers and supplementary feeding rates during the second half of the season. As a result, milk production is forecast to remain in line with 2007-08 at 9.2 billion litres.
- The 2009-10 season hangs in the balance with the prospect of lower farmgate prices requiring a significant improvement in climatic conditions to reduce production costs and support farm margins.
- While early signs have been encouraging, a comprehensive autumn break remains elusive. In lower Murray Darling basin, inflows will need to be at least average to ensure irrigators receive a water allocation to support spring pasture production, and reduce their heavy reliance on purchased feeds.
- With the economics around milk production changing so dramatically over the last 12 months, forecasting is particularly difficult. While production intentions stated in this year's survey were not significantly different from 2008, the 2009-10 season hinges on an opening price that can sustain a margin above feed costs. In turn, feed costs hinge on the rainfall received in dairying regions over the next six months. Both factors remain highly uncertain.
- At this stage the forecast for 2009-10 is for little growth in milk production to 9.0 to 9.2 billion litres, with the risks more on the downside in this forecast.

- Looking further ahead, three year production intentions from the 2009 survey were also in line with the intentions recorded in 2008. With reasonable seasonal conditions and prices, milk production could range between 9.7 and 10.1 billion litres by 2011-12. However, with the possibility of increased farm and cow exits over the next 12 months, this increase may be difficult to achieve.



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