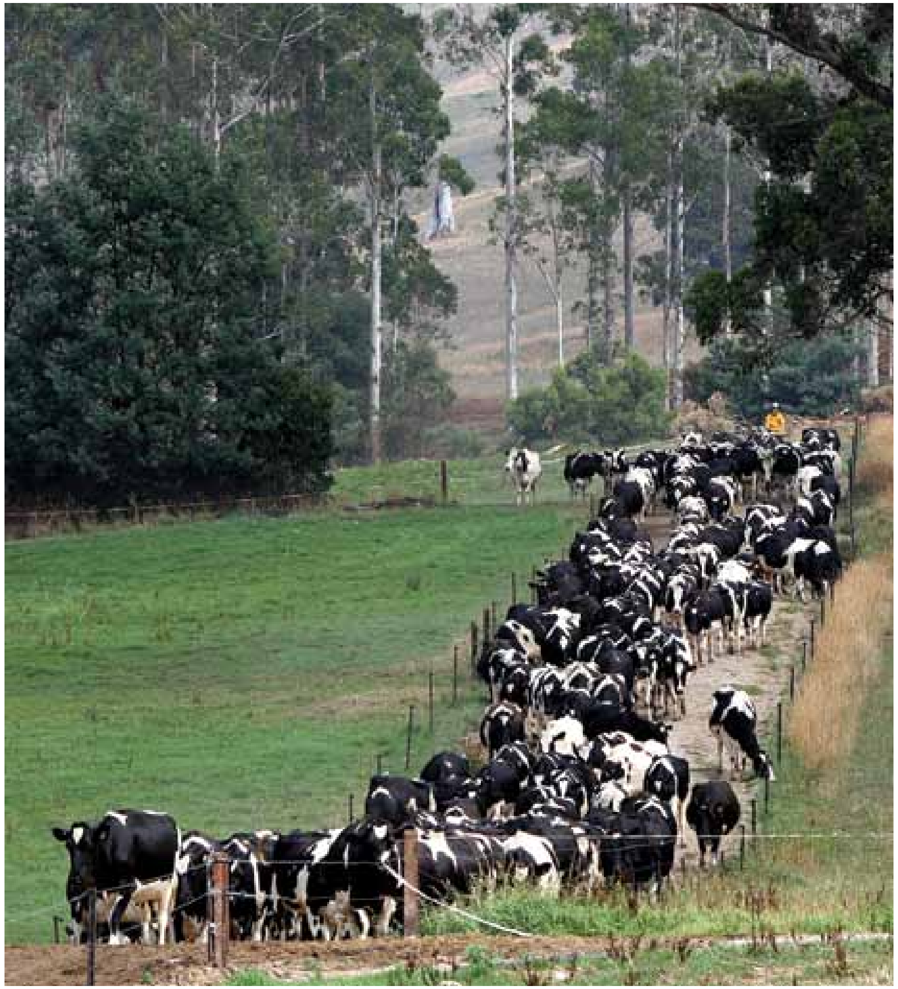
Dairy Australia
Your Levy at Work

Dairy 2010
Situation and Outlook
Summary Report

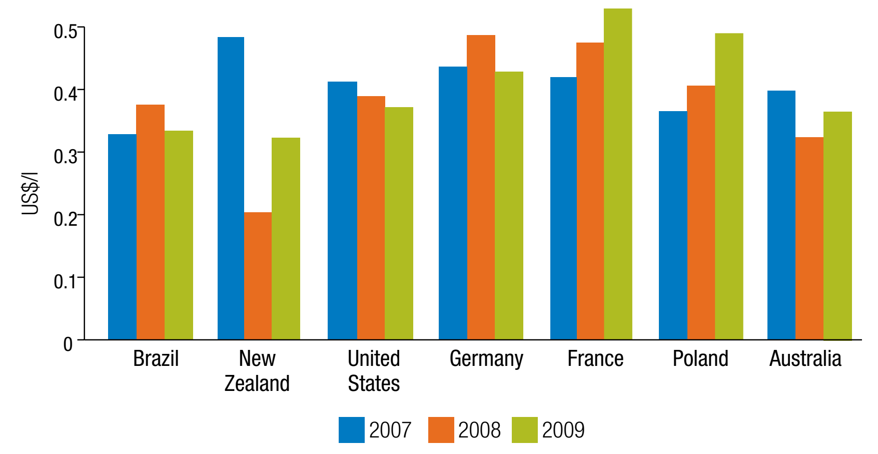
The industry in 2010—riding the rollercoaster



- Operating conditions for the Australian dairy industry have improved dramatically in 2010. In 2009, the industry was facing a crisis, with the global economic downturn cutting milk prices, and continued dry conditions placing many farm businesses at risk.
- In 2010, the industry's position has changed significantly for the better. Economic recovery has underpinned renewed demand growth in key markets. Meanwhile reduced supplies have seen dairy commodity prices rise sharply in US dollar terms. This has seen a return to the fundamentals of the dairy market—without the overlay of a financial and economic meltdown.
- While the benefit of the international market recovery for Australian exporters and farmers has been constrained by the strong Australian dollar, farmgate prices for southern producers have improved in the second half of the 2009–10 season from relatively low opening prices compared with the past two seasons.
- Improved milk prices, combined with low grain prices and generally favourable seasonal conditions see southern farmers enjoying the best production conditions for several years. Nevertheless the negative cash flow conditions of 2009 are still weighing heavily on farm businesses—with debt estimated to have increased by an average of 20 per cent over the two years to 2009–10. Increased debt loads and higher interest rates will maintain pressure on farm finances.

The industry in 2010—riding the rollercoaster continued

Average Farmgate Pricing



- The 2010–11 opening farmgate milk price announcements will again be important signals for farmers assessing their short-term decisions and their longer term future in the industry. While uncertainty remains, particularly around currency, opening prices will be considerably higher than last year. Dairy Australia's forecast range for opening price of around \$4.40–\$4.60 per kg milk solids (kgms), implying a full year price range of \$5.00 and \$5.40 per kgms. This is assuming dairy commodities trade at around current levels and the Australian dollar remains between 90 and 95 US cents. While dairy market fundamentals support this price outlook—the wider global economic situation remains the greatest threat to a sustained market recovery.

- Market and margin volatility has undermined confidence for many dairy producers, in particular younger farmers with low equity. Caught by the sudden downturn in milk price, they are financially stretched and uncertain of their ability to withstand future volatility in their returns.

- The low growth situation and outlook resulting from this uncertainty is intensifying the contest for sustainable regional supplies. Competition for milk between dairy manufacturers remains strong, due to increasing export demand, the need to fill factories and support future expansion plans.

- In northern states, conditions for dairy farmers have been relatively benign over the past year, with contract prices remaining in place for most dairy producers, and seasonal conditions generally favourable. As a result, milk production has expanded beyond the requirements of fresh milk processors in the region. This adds to margin pressures being experienced due to the lack of wholesale price improvements in the retail market. As a result, processors are building in sharper signals designed to limit further growth into new contracts.

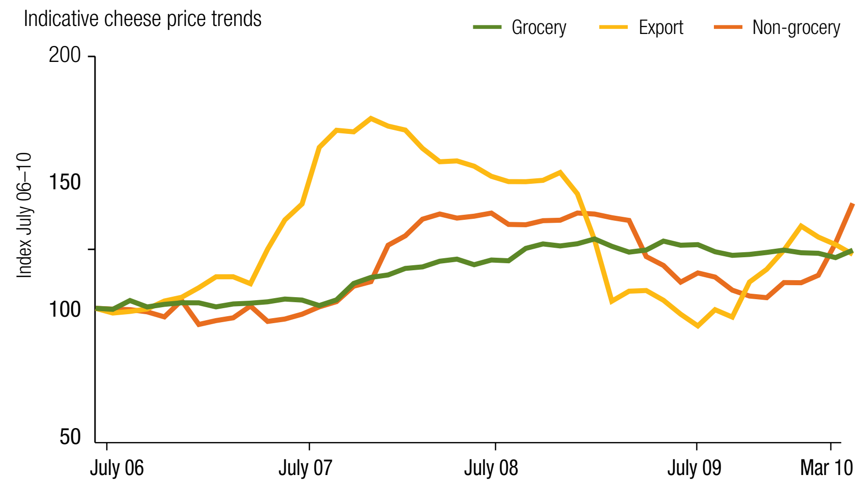
- While the turnaround in external operating conditions for most farmers is remarkable, confidence levels are unchanged. The volatility of the industry is undermining confidence in the outlook for many farmers who are seeking reliable returns on which to build a longer term future.

- Others are quickly adapting their production systems and responding to the changeable environment—confident in the ongoing demand for dairy products and their ability to sustain and grow their own business.

Australian market Situation & Outlook

- The Australian economy has emerged relatively unscathed from the economic downturn. Household incomes have continued to grow steadily over the past couple of years—having directly benefited from government payments and sharply lower interest rates, as well as the effect of these measures in keeping unemployment low.
- As the international market downturn hit, the Australian dairy market proved resilient, providing volume and value growth throughout 2009.
- Households responded to the uncertain economic conditions in 2009 by tightening their food spending, reducing eating out and opting for cheaper grocery options. Retailers have sustained aggressive price strategies.
- There has been a volume shift towards the grocery channel, contributing to growth in supermarket sales across most dairy categories, with some reversal of the trend toward private label products resulting from improved consumer confidence and aggressive brand promotion.
- As production has contracted in recent years, the local market has accounted for an increasing proportion of the industry's production—around 55 per cent of annual output. The Australian market will continue to represent a relatively "safe haven" of steady sales growth for the industry with neither the extreme highs nor lows of the international commodity market. Companies supplying the domestic market are positioned to push for margin recovery, given the tight supply situation and improved export opportunities.

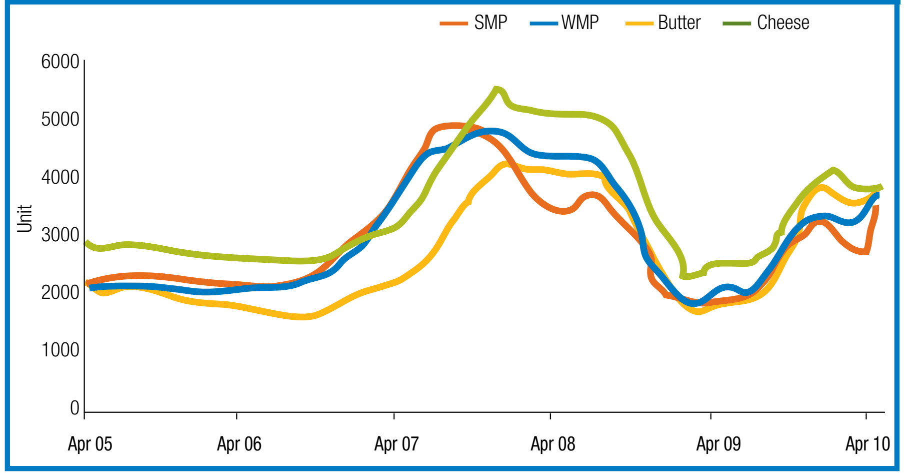
Domestic vs export price trends



International market Situation & Outlook

- The international dairy market has become increasingly volatile over the past three years. Drivers of this instability include:
  - the global economic environment which impacts demand and affordability;
  - structural changes in the global market with emerging suppliers and lower structural surpluses of stocks in the Northern Hemisphere;
  - highly variable weather impacting on exporting regions;
  - variable input costs impacting on farmers production intentions;
  - new market indicators such as *global*DairyTrade online auction results; and
  - changed buyer behaviour due to uncertainties caused by a combination of these factors.
- Spot international dairy commodity prices have increased by 80 per cent in US dollar terms, since their February 2009 low, reflecting improved economic conditions and tight supply. This has taken commodity prices back to the levels of two years ago, suggesting the worst of the global financial crisis effects are over. While retail demand appears healthy, buyers remain cautious—buying "hand to mouth" rather than rebuilding stocks, and adding to ongoing volatility.
- The demand recovery has been led by China, indirectly as a major driver of the global economy, and directly as a significant and growing importer of whole milk powder. Many retail markets in developing countries are segmented, and with limited supplies, Australian exporters are concentrating on higher value segments to maximise returns—for example, infant formula for China.

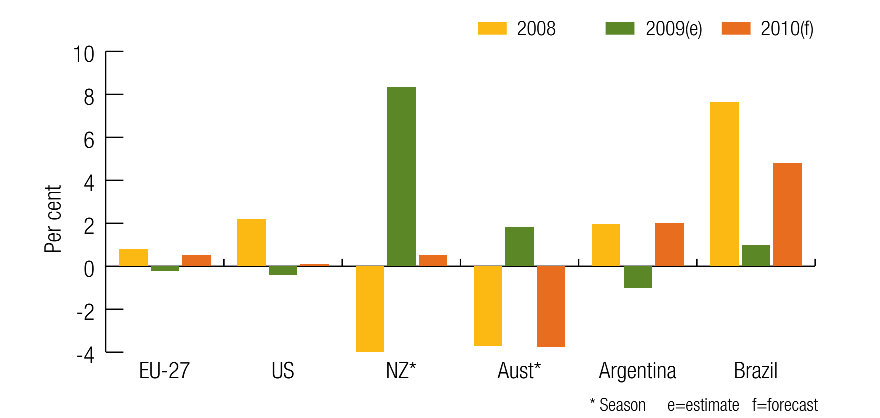
Dairy commodity prices



- Powder demand from South East Asia has remained resilient, as has Middle Eastern consumption of cheese and other products. Japanese cheese demand remains weak and internal supply and demand issues are limiting the requirements for imports.
- As dairy prices rise and volatility increases, substitution of dairy ingredients for non-dairy fats and proteins becomes a greater risk—particularly as grain and soy bean prices have been slower to rise in this current cycle. This poses a longer term threat for dairy demand, as once reformulation has occurred, ingredient buyers are reluctant to return to dairy products.

World supply

Milk production trends—major suppliers

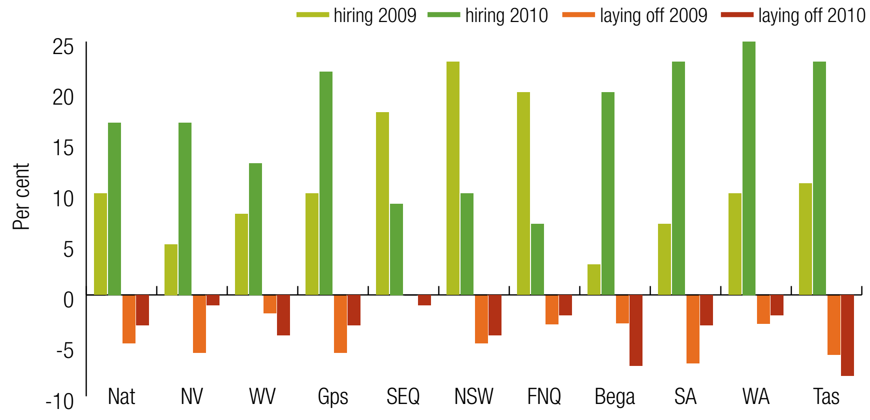


- World milk supply grew by just one per cent in 2009, below the longer term average of two per cent as farmers responded to cuts in milk price and profitability. With higher commodity prices being passed through the supply chain gradually, and farmer confidence and finances under pressure, a significant supply response is unlikely in 2010.
- After re-instating market support measures in 2009 and re-building government stocks, the US and the European Union (EU) are no longer intervening in the global dairy market. Government stocks did not reach historical levels and are largely committed to domestic programs limiting their impact on international trade.
- US milk production finally contracted in 2009, with higher mid-west production offset by falls in Californian output. With the US milk price to feed grain ratio approaching expansion levels once again, milk production is expected to grow slightly in 2010—however the significant financial pressure felt by larger farmers is likely to constrain their ability to respond.
- In the EU, cold and wet conditions have delayed the spring flush of production, adding to shortages in fresh supplies and reducing the likelihood of significant growth in 2010. Increased internal cheese consumption and strong Algerian demand for milk powders is likely to limit production of butter and SMP for export. However, the weak Euro is enhancing the competitiveness of EU exporters.
- New Zealand milk production growth will be less than 1 per cent in 2009–10, due to drought conditions affecting the North Island. Production is expected to return to longer term average of two to three per cent growth in 2010–11 as farmers respond to higher payouts.
- Despite a slow start, milk production is expected to expand in Brazil and Argentina in 2010. However, increasing domestic consumption is likely to limit the availability of product for export.

The farm sector in 2010

Employment changes

Percentage of farms that are planning employment changes



- Surveyed average herd size was 258 milking cows in 2010. Nationally, 29 per cent of farms reduced herd size in 2009–10 compared to the previous year, while 32 per cent of farms increased the number of cows milked
- Average milk production per cow was estimated to be 1.5 per cent higher in this year's survey compared with 2009.
- Farmers surveyed in southern regions reported a shift toward feeding systems that incorporated more pasture and lower rates of supplementation. Nevertheless, the amount of grain fed per cow has not changed significantly, averaging 1.5 tonnes in 2010 compared to 1.53 tonnes in 2009.

The farm sector in 2010 continued

- Nationally 35 per cent of farms had a period in the previous 12 months when their herd did not graze, relying entirely on conserved fodder, grains and supplements. This is down from 2009, when 45 per cent of herds did not graze for a period.
- Irrigated dairy farms were able to water 61 per cent of the area set up for irrigation in 2010, up slightly from 2009, when just 58 per cent of that area was watered during the previous 12 months. The proportion of farmers using purchased water was down significantly from 33 per cent in 2008–09 to 15 per cent in 2009–10.
- 50 per cent of farmers believed they would make a margin over costs for the period January to June 2010. Respondents feeding more than 1.51 tonnes of grain were significantly more likely to make a margin over costs compared to those feeding little or no grain.
- Nationally, calving patterns are unchanged, with the proportion of farms seasonally calving at 36 per cent. Split calving characterised 33 per cent of farms nationally, as in the last two years, however there were significant regional shifts toward this system reported in South Australia, Western Australia and Tasmania. While year round calving continues to dominate in regions with a high requirement for fresh product supply, it accounts for 30 per cent of farms nationally.
- 31 per cent of farms were staffed solely by the owner or ownership couple in 2010, compared to 28 per cent in 2009 and 43 per cent in 2007.
- 17 per cent of farms were planning to recruit staff over the next 12 months compared to 10 per cent in 2009, while three per cent of farms planned to lay off staff (compared to five per cent last year). Intentions to recruit increased strongly in southern dairying regions, while farmers in the northern states were less likely to be hiring staff in the coming year.

What did farmers say?

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

Attitude and Challenges

- 65 per cent of farmers were positive about the future of the national industry in 2010, in line with 2009 (66 per cent). Positive sentiment was most often linked to a belief that there would always be demand for dairy products, but also with the expectation of improved milk prices. Low milk price was the main driver for negative sentiment.
- Surveyed farmers were similarly positive about the industry in their local region, but were significantly more confident about their own business—with 70 per cent of respondents feeling positive about the future of their farms.
- Milk price was the greatest current and future challenge mentioned by farmers in 2010. Climate, and the cost and availability of irrigation water were the next most often mentioned challenges, both currently and in the future.

Investment

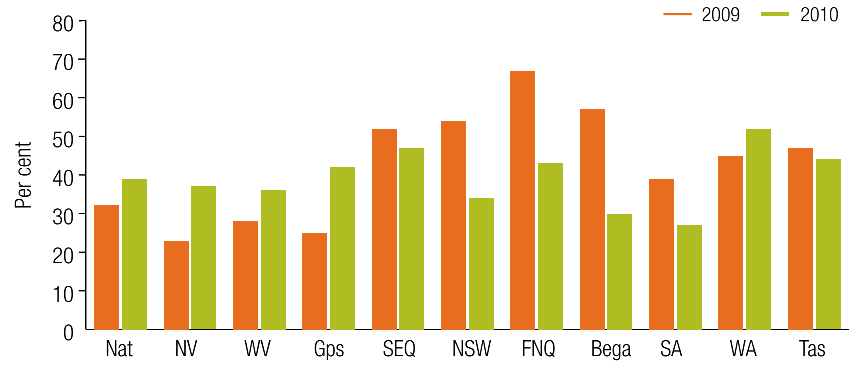
- 65 per cent of dairy farmers made on-farm capital investments in the previous 12 months, in line with 2009 (67 per cent). Machinery remained the main area of investment, followed by dairy and irrigation plant. There was a significant increase in the proportion of farmers from New South Wales and Queensland investing on-farm.
- 39 per cent of farmers were planning on-farm investment over the next 12 months, up slightly from 32 per cent in the 2009 survey. After increasing investments in 2009, farmers in northern states indicated they are less likely to invest on-farm in the coming year, while farmers in southern regions are planning to increase their investment in 2010.

Attitude to industry future

Attitude to the industry – comparing 7 surveys

Investments on farm (intent)

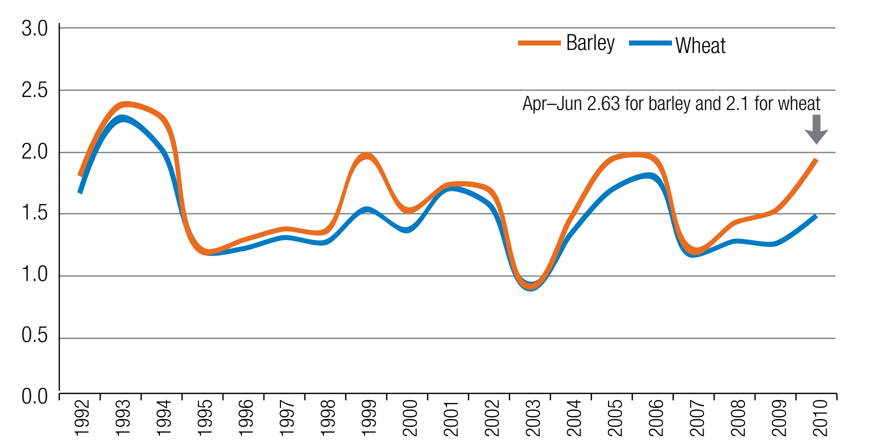
Percentage farms intending to invest in next 12 months (comparing 2009 and 2010 surveys)



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.
- The ABARE survey reported a dramatic drop in national average farm cash income in 2009–10 to $50,000—down 43 per cent from last year's $88,000 figure. This reflects the low opening and early season milk price in southern regions. At one end of the spectrum farmers in the Northern Victoria/Riverina region were expecting farm cash income of -$27,300 while Western Australian farmers were expecting to average $240,500. The percentage of farms with a negative cash income has lifted from 26 per cent to 44 per cent in 2009–10.

Milk to feed price ratio—Victoria

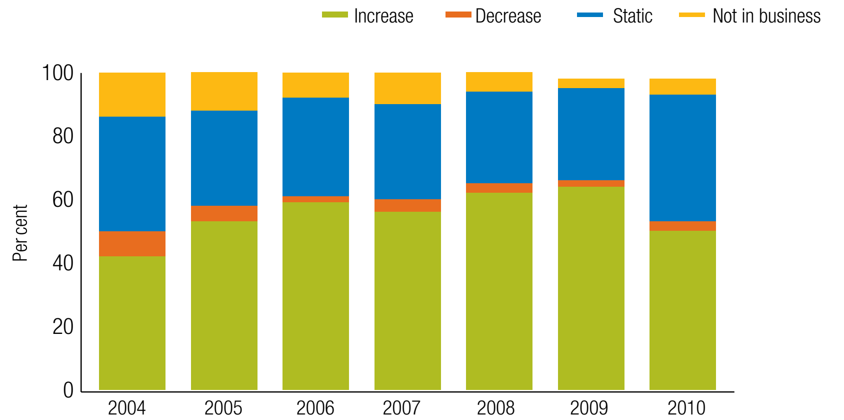


- The ABARE survey reports that average farm debt lifted again this season —up to an estimated $683,000 per farm—an increase of 20 per cent over two years ago.
- Interest payments are the second largest expense item for dairy farmers —representing an estimated 10.7 per cent of average of dairy farm cash costs in 2009–10 according to the ABARE analysis—increasing from 9.5 per cent last season and 9.1 per cent the prior season.
- Increases in official interest rates coupled with increasing short and long term debt loads will maintain pressure on many farm finances in southern regions. The conditions of the past 12 months have increased the polarisation of farm businesses dependent on their region and their exposure to the international market. For example, farmers in south-east Queensland and northern New South Wales reported average debt levels of $999 per cow, less than half the debt reported in northern Victoria ($2,077 per cow) and Tasmania ($2,406 per cow).
- Dairy farmers have made some use of Farm Management Deposits (FMDs) to manage their cashflow in 2009–10—particularly in Victoria and Tasmania. The other states showed a much lower rate of drawing down of these funds.
- While the total value of dairy FMDs has fallen from a record high of $240 million in June 2009 to an eighteen-month low at just over $200 million in December 2009; they remain well above the average value of $160 million for the three years prior to June 2008.

Milk production outlook

Changing growth outlook

Expected production in three year's time – comparing seven surveys



- Milk production in 2009–10 contracted as a result of sharply lower milk prices and a poor start to the season in southern states, which prompted many farmers to reduce herd numbers. As a result, with the lower peak production, total national output is forecast to fall to 8.95 billion litres.
- The 2010–11 season offers significantly better prospects with higher farmgate prices, lower grain costs and a better autumn in most areas. In northern Victoria irrigators are enjoying their best water allocation for four years.
- However, the financial position that many farmers in southern Australia find themselves is limiting their ability or willingness to expand production, indeed many farmers are still assessing their future in light of the volatility they have experienced in profits over the past few years. This is clouding the outlook for milk production in 2010–11.
- At this stage the forecast for 2010–11 is for 9 billion litres, however, with NDFS respondents indicating a two to three per cent increase in cows milked in spring 2010, there appears to be some upside in this forecast.
- Looking further ahead however, three year production intentions from the 2010 survey showed a significant decline in growth expectations compared to the 2009 survey, with a larger proportion of farmers intending to produce around the same as in 2009–10. Based on the surveyed expectations, and with reasonable seasonal conditions and prices, milk production could range between 8.9 and 9.2 billion litres by 2012–13.
- The surveyed intentions seem to reflect the uncertainty brought about by the unstable market conditions and the impact on farmers finances. However, there is significant upside to this forecast if the current turnaround in southern seasonal conditions and pricing remains in place.

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