Savills Agribusiness

Dairy Review:

KEY POINTS

- Farmgate milk price cuts of up to 2ppl on the back of weak commodity markets, further price cuts may follow in the summer
- UK milk production has increased following a period of decline and the rate of increase in US, Australia and NZ has quickened
- Weaker sterling could expose UK markets to imports especially from Ireland
- Good profits are made when the cost of production is low (whether
- UK market has some protection by virtue of the fact 50% of milk sales are liquid
- Retailers have set up their own direct supply groups to secure supplies
- Devolved regions are more exposed to CAP reform than England but may opt for coupled payments to avoid a producer exodus
- Dairy farmer confidence will be eroded by falling milk prices which may slow reinvestment and expansion
- Tenants face additional pressure from higher rents and low capital reserves
- Milk contracts are a key determinant of enterprise profitability

INTRODUCTION

While the fall in the milk price of up to 2 pence per litre earlier this month sent shivers through the UK dairy industry, long term decisions such as whether to expand, contract, cease production or build new dairy units need to be based on the longer term prospects. While there is never complete certainty and the unexpected can happen, some fundamental considerations and analysis can help with the strategic decision process. This article provides a brief summary of Savills recent analysis of the sector.

THE BIG PICTURE

Globally, there is not a fundamental constraint on dairy production (and even EU milk quotas will be abolished in 2015). Therefore, when dairy prices show a sustained rise, milk production increases and in doing so, prices are eventually lowered to the breakeven point for the least efficient producers.

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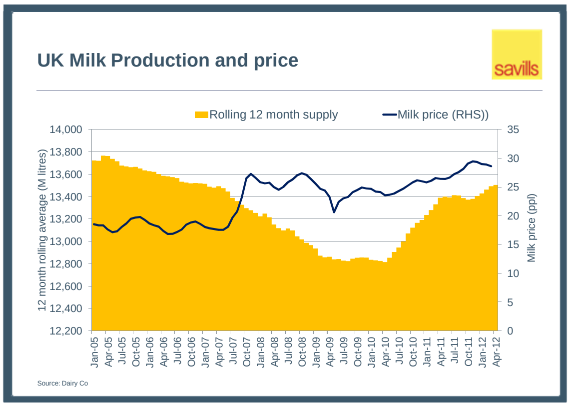
UK Milk Production and price trends



The economic situation is clearly more complicated than this since expansion requires investment and expertise, and the response to high milk prices is not immediate. Thus, higher profits can be made during periods of adjustment. Transport costs and other logistical barriers may result in high local prices, which is an important determinant of the liquid milk price (largely thanks to a relatively short shelf life).

Import protection (latterly the weakness of sterling has been a form of import protection) can raise prices, although this is seldom in the interests of the consumer and assumes the cost of production is higher within the UK than globally.

However, good profits are made from dairying where the cost of production is low compared with the remainder of the industry.

THE BIG QUESTIONS

- Is the fall in farmgate milk price a blip or will it be sustained?
- Is my dairy enterprise competitive internationally in the long-term?
- Can competiveness be improved?
- Are there new opportunities to explore?

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THE UK

Liquid milk represents more than 50% of the UK market making the UK an unusual market in a global context. Liquid milk buyers tend to pay more than processors for the supply of milk but the processing price determines the liquid price. Demand for processing therefore diverts supply from the liquid market when global product prices are high (or sterling is weak) forcing liquid buyers to pay more to secure supply. The liquid market is relatively price insensitive and liquid buyers need only to pay enough to secure supply (reduced levels of national production prior to 2012/13 has driven some of the major retailers to set up their own dedicated supply groups as a means of securing their own supplies of liquid milk) and can pass any higher price on to the consumer with only slight implications for demand.

Most traded dairy products are not branded (skimmed milk powder) or difficult to brand (butter). Cheese is an exception and can be branded. However, Cheddar is the only major UK cheese brand but it does not have protected name status and is produced in significant quantities by most exporting countries resulting in strong competition. Irish dairy expansion targets inevitably mean that competition will be fierce in the future as the UK is a key market for Irish dairy products.

If the CAP reform takes place as proposed, the loss of a historic based subsidy system would hit non-English farmers hard and, for example, the rate of decline in the herd elsewhere might increase to match the decline already recorded in England. However, approximately half of the EU member states already give extra assistance to dairy or grassland farmers and it is quite possible that there would be an increased coupled payment for dairy producers elsewhere.

ARLA (Danish farmers co-op which operates across Europe including the UK) has announced it is merging with Milk Link (one of the successors to the Milk Marketing Board/Milk Marque) to form the UK's largest milk processor with 3000 members supplying 3.2 billion litres of milk per year (a quarter of national production). This is broadly seen as a positive move for the industry.

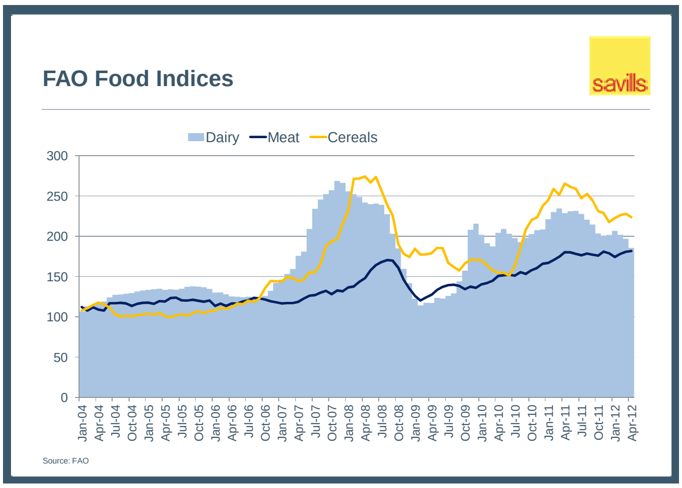
THE INTERNATIONAL MARKET

According to the FAO, dairy prices have clearly risen since 1990 but so too have other foodstuffs. More detailed analysis shows that

1) Since 2000 dairy prices fell slightly against cereals and oilseeds but strengthened significantly against meat

2) Dairy prices have risen relative to other food commodities since the beginning of this calendar year making a correction likely – but still within an upwards trend.

FAO Food Indices



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Production in all the major exporting blocks (New Zealand, Australia, US and EU27) has been relatively high since the start of the year at least in part due to favourable weather. Unfortunately, sterling is also now strengthening against the euro and US dollar, which is having another negative effect.

DAIRY SCORE CARD

In order to rationally assess future prospects there are a number of basic farm considerations including:

- pollution risk;
- versatility of land;
- cost of feed source (grass and distillers grain from ethanol manufacture reduce exposure to grain price risk and exchange rate);
- size of unit (impacting not just on labour but also cost of milk collection).

In the short term, the specific contract with the buyer can have a major impact on profitability. However, headline figures may not be sufficient to determine on farm price. Contract ranking varies with seasonality and payments for milk solids.

Most on farm structural issues can be dealt with although the solution will often require investment thereby increasing exposure. There is often a temptation to make “sticking plaster” changes with the result that a problem is dealt with but long-term profitability is not improved.

In some situations, joint ventures with other producers can lower costs and help supply capital. The return to each party should reflect risk and the level of investment.

Vertical integration (linkage from producer through processor ultimately to retailer) can increase returns but it is not a panacea. The advantages have to be identified before putting arrangements in place. The advantages may be as simple as undervalued capital or shared promotion costs. The most satisfying supply chain joint ventures are where communication is improved so that the highest return overall is produced with an equitable division of the return between the participants. Inevitably, this will involve innovation in terms of products or business structures.

There are also new grant schemes available that can help deal with some of the problems facing the sector.

IMPACT ON RENTS

Both new lettings of dairy farms and rent reviews for AHA & FBTs have continued the upward trend of recent years. The recent milk price cuts were not widely anticipated by the industry (no mention was made at a recent conference organised by Dairy Co) and it could be some time before we know the full impact. Iin the short term dairy farmers are continuing to invest and expand but in the longer term if the milk price falls further or remains static a number will be loss making. A a recent report from the Dairy Group forecasts total cost of production will rise to 30.1ppl in 2012/13, whereas the Tesco milk price tracker which is seen as a benchmark for the industry has set the price for the six months from April 2012 at 29.56ppl. Tenants inevitably will be particularly exposed as rent makes up a major part of their cost base and they have less capital than similar owner-occupied businesses.

Any negative impact on rent is likely to have a time lag and will be specific to the holding in terms of:

- timing and outcome of last review?
- size of holding and standard of facilities
- alternative land uses
- relative split of landlord and tenants investment
- who the milk buyer is and what alternatives there are in the area?

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