

MARKET UPDATE

Monthly Market Summary for Members of DFMC



February 2011

Milk wars threaten category value

The latest phase in the retail price wars will hurt milk returns.

This pressure on milk returns has increased dramatically following the announcement by Coles – quickly followed by Woolworths, Aldi and Franklins – to cut private label milk prices to around \$1-00 per litre for 2-litre and 3-litre bottles as part of a price war between the major retailers.

The retailers differ in their views as to the length and sustainability of these prices. The industry fears the following impacts:

- o In the short-term, the wider gap between private label and branded products will shift more share of the milk market to the lower-priced product, weakening the overall wholesale returns to processors. This will happen not only within the grocery store, but also between route business and grocery. There is already plenty of anecdotal evidence that private label lines at a grocery store is a cheaper source of milk for cafes who depend on the route trade for supplies.
- o If these prices prevail until the middle of the year, it will not only affect the wholesale prices at which private label lines are packed by processors, but likely flow-on into reduced farmgate prices.
- o The longer the milk price war prevails, the brand proposition weakens, undermining the viability of marketing and product innovation. Returns from branded products are critical to the mix of returns to processors, which naturally flow-on to affect the affordable values of milk at farmgate.

A very strong dairy industry backlash has led to a Senate Inquiry being called into the pricing of milk products. After the last inquiry – into Tasmanian milk prices that dragged out to attempt to analyse overall milk market returns, not a lot of hope is placed on such a political process as having any teeth, given that retailers are well-versed in defending their practices to politicians – especially in a time when consumers are still cautious in their food spending.

The retailer price war isn't a new thing – Freshlogic has been tracking its intensity since the middle of 2008 when the recession loomed. It has simply taken on a different form since late 2010 (when heavy discounting started in the meat department) and has now been extended more widely into staple foods since 2011 started.

Value stripped

Dairy Australia's analysis based on retail sales numbers suggests that for sales by Coles and Woolworths alone the full annual effect of the price reductions is about \$75 million (provided there is no change in consumption). This effect excludes the impact of any shift in volumes from branded milk to private label as a result of consumers switching to the cheaper option.

New Year opens with step-ups

Companies declare step-ups – expect two more from each

Murray Goulburn stepped-up its farmgate milk price and maintained its full-year price forecast. MG advised an increase of 35c/kg protein and 14c/kg butterfat for milk supplied during the 2010-11 season. MG's CEO Steve O'Rourke advised that the co-operative's forecast final milk price for this season had been maintained at a range of \$5.30 to \$5.50 per kilogram of milk solids. Fonterra earlier stepped up Victorian and Tasmanian milk prices by 8c/kg fat and 20c/kg protein, or about 13c/kg milk solids. Tatura has also lifted prices and has now announced three lifts in price since its opening.

Major companies are each planning at least two more price rises. The pressure will stay on that performance as dairy markets remain strong and companies will be doing their best to get every litre they can in southern regions. Higher 2nd half prices will be needed as the cost of grain rises.

Important market indicators

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| Dairy export index | The index has improved 13% in early 2011 to be at 137 at the time of this summary. |
| World dairy prices | Prices have firmed in recent weeks as supply shortages from several exporters and importing countries become a reality. |
| Australian dollar | The \$A continues to hover around parity. |
| Grain futures | Feed grain prices in world markets remain high due to fears of a shortage of crop output. Local feed grain prices have gained in early 2011 as importers have snapped up large orders |
| Cow prices for cull exports to the US | The US market for Aussie cull cows remains strong with a tight of meat supply within the US. |

Situation & Outlook – 1st Qtr update

Dairy Australia has released its February 2011 update which carries major messages including:

- **Australian milk production** is on track for between 9.0 and 9.1bn litres in the 2010/11 full season – little changed from last year;
- The availability and cost of cows is the **significant impediment to significant expansion** offsetting gains from good milk prices and lower feed costs;
- **Export prices are firming**, driven by steady global demand and limited milk and product supplies in major importing countries. High prices are approaching buyer resistance levels – that might mean export prices may not rise much past where they are. Upcoming NZ auction prices will be important to watch;
- **Chinese demand** for milk powder – a key factor in a tight global market – remains strong and is expected to grow further;
- The **effects of floods** from current La Niña event disrupted milk production in South Qld and Northern Victoria. Production losses may be 50-60m litres in 2010/11 depending on farmers' ability to recover feed supplies and cow condition.
- The **price war in milk products** between major grocers may directly affect private label milk sales in grocery stores, but the extent of the aggressive pricing will affect branded lines in and out of the supermarket.
- The situation will result in greater political scrutiny of the milk sector, and – if it remains in place for several months – will affect supply chain returns for processors and farmers in Qld, NSW and WA.

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World dairy market returns

World market stronger as shortage bites

While a lot of attention is being placed on an acute issue in the domestic milk market, the world market in the background is getting better. At the time of this report the index of Australian export returns had strengthened to 137 points over the period since the start of the year, a gain of 13% since Christmas.

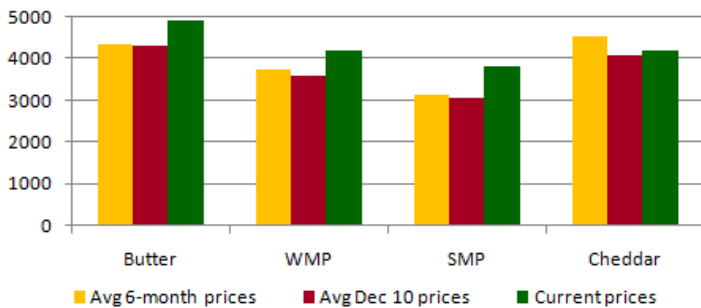
Sentiment in the world market has changed back to a fear of shortage as dairy markets tighten and the cost of feed grains continues to rise – suggesting production might be curtailed in a number of major exporters, and in industries that depend on some imports.

NZ production is just ahead of last year after rains broke fears of a major drought but output will be well below expectations. US and EU milk suppliers are also ahead of prior year numbers but keeping pace with domestic demand.

Spot prices giving a good lead

Australian export returns are rising with current spot prices (which reflects marginal sales at the current time) well ahead of average achieved prices for December and the last 6 months of 2010. These prices should mean expected step-ups from Victorian manufacturers are delivered, pushing average Victorian milk prices to the 38-40c range over the full season, or \$5.30 to \$5.50/kg milk solids.

Avg Australian export prices
6 months to dec 10 vs dec 10 vs spot

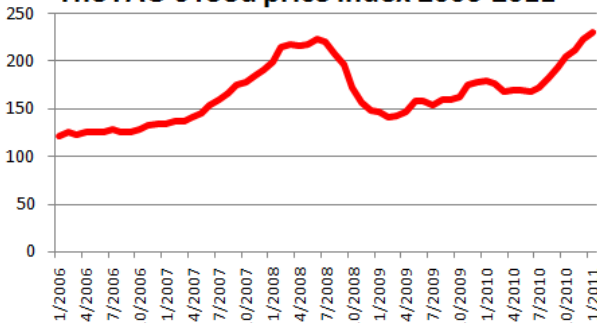


Price of food must rise

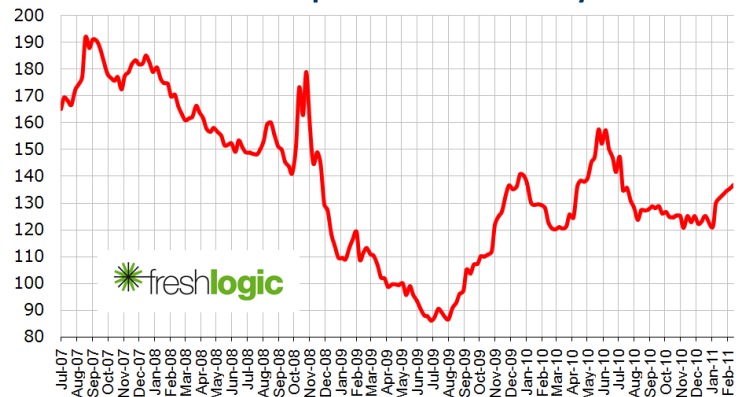
Commodity prices hit their highest – the flow-on to consumers will follow

Commodity food prices around the world surged to a new historic peak in January, for the seventh consecutive month, the United Nations' FAO said. According to the FAO, its latest *Food Price Index*, a commodity basket that tracks monthly changes in global food prices, averaged 231 points in January and was up 3.4 per cent from December last year – the **highest level** since the agency started measuring food prices in 1990.

The FAO's food price index 2006-2011



Australasian export index from July 2007



Take note: The index is an indicator of spot trends in gross export returns to the industry based on quoted Australasian export prices, movements in currency and the total milk usage in exports by the Australian industry. It was first published in January 2004.

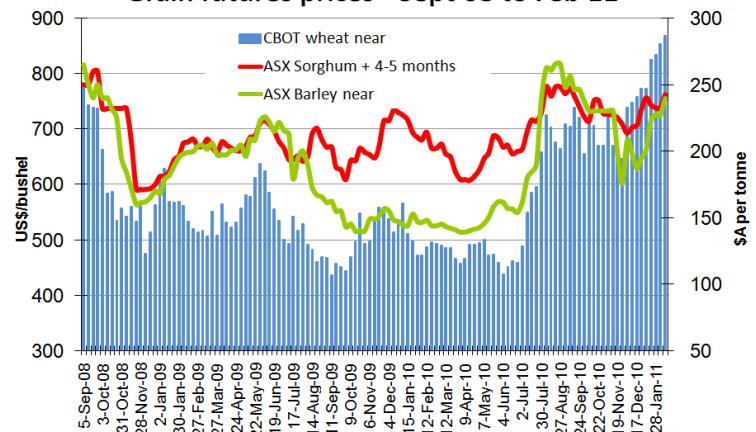
Feed prices on the march

Smaller crops and stocks push up prices.

World grain prices have surged in early 2011 as a smaller US grain crop compounds the shortages for food wheat, and knocks onto feed grains markets. Record volumes of down-graded wheat and barley mean that supply within Australia is not going to be an issue, perhaps for up to two years, although exporters will compete with local users as global demand for feed grains will remain strong, replacing high priced US corn into the Philippines, Vietnam and other south-east Asian markets. This demand will keep prices firm in coming months.

Our chart below shows how the global benchmark for food wheat (the US Chicago cash price) is moving in synch with local feed futures prices.

Grain futures prices - Sept 08 to Feb 11



Cull cow values stay strong

The US market for culls remains tight

The US market prices for manufacturing meat which drives the value to Australian abattoirs for cull cows has come off its highs reached in January with the combined effects of lower culling in the US dairy herd, poor US winter weather stopping animal movements and the reduced availability due to Australian floods affecting imports from Australia. Prices have lost a little ground in the past 2 weeks but remain historically high.

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