

# When the market turns

A discussion document on the immediate prospects for the dairy market



Prepared by  
Kite Consulting

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*Kite*

# About Kite Consulting

Kite Consulting is a modern consultancy company focused on delivering excellence to customers in farming and the allied industries. We operate a team approach and our partnership of more than 20 national specialists and leading business and technical consultants provides high calibre consultancy across the UK and internationally.

Kite provides business services to the entire food supply chain. Recognised as a specialist in the UK dairy industry, we also work with livestock and arable businesses, serving market sectors including farming, the agricultural supply trade, food processors, retailers and public sector organisations. In addition, we are recognised for our pioneering environmental work, particularly on the carbon footprint of primary production.

We are proud of our knowledge base and our relationships, which are unique in fostering communication and understanding across the entire chain from farm to retailer.

This discussion document has been prepared by Kite's Milk Marketing Network – John Allen, Neil Blackburn, Chris Laycock, David Levick and Edward Lott.

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# Executive summary

In recent months there has been considerable change in world and domestic dairy markets and as a result a number of reports have been published by respected dairy industry organisations debating the future direction of our industry. We believe that these reports make valid points and this discussion document reviews current thinking and updates our previous analysis.

In summary, we believe that:

- The UK dairy industry is ahead of Europe in terms of restructuring and our analysis shows the opportunity to stabilise milk production in the years ahead, if farmers have the confidence to invest and grow their businesses, as the heifers are in the pipeline.
- World stocks levels will be a primary influence on world market prices moving forward. Tracking stock levels will therefore be important as small changes will have a significant impact on price. Better information is required, as already found for most other major agricultural commodities.
- Although we face a volatile future, profitability for good dairy farmers will improve in the medium term compared to recent years.
- The current market dynamics will widen profit differentials - the rewards for efficient, flexible businesses will be greater whilst inefficient businesses will be exposed and more likely to fail.
- Trust and confidence throughout the supply chain is vital. Customers must ask themselves what they are doing to build trust and encourage stability, for the benefit of everyone in the supply chain.



# Introduction

The last twelve months has seen unprecedented turbulence in world dairy markets. The global economy has entered recession, impacting on the demand for high value dairy products as well creating significant currency valuation changes.

Worldwide, dairy supply has increased whilst demand, particularly in Asia and developing markets, has slowed resulting in commodity market prices crashing with a corresponding decline in farm gate prices. Indeed, globally it is now the case that most milk is being produced below the cost of production.

Closer to home, the GB market has been isolated to an extent from the wider market due to the relative weakness of Sterling and the increasing prevalence of cost of production factors in retailer-linked farmer contracts. Yet milk prices have still fallen on the back of a slight decline in cost of production and the dramatic downturn in contracts linked to the commodity cheese and milk powder markets. And farmer confidence remains fragile. Milk production is at its lowest level since the 1970's and 2008 saw raw milk imports into GB for the first time.

Whilst we are currently facing a downturn in dairy prices and volatility is here to stay, market analysis suggests that the market will return to balance and that the UK is well placed in the medium term. It is not considered a matter of 'if' the market turns but simply a matter of 'when'.

This discussion document therefore explores the issues that will impact upon the dairy markets moving forward and provides analysis on the future prospects for the UK dairy industry. It does not focus in any depth on market developments over the last twelve months as these have been well documented elsewhere, but instead looks at the challenges and opportunities for the dairy industry in the short to medium term.

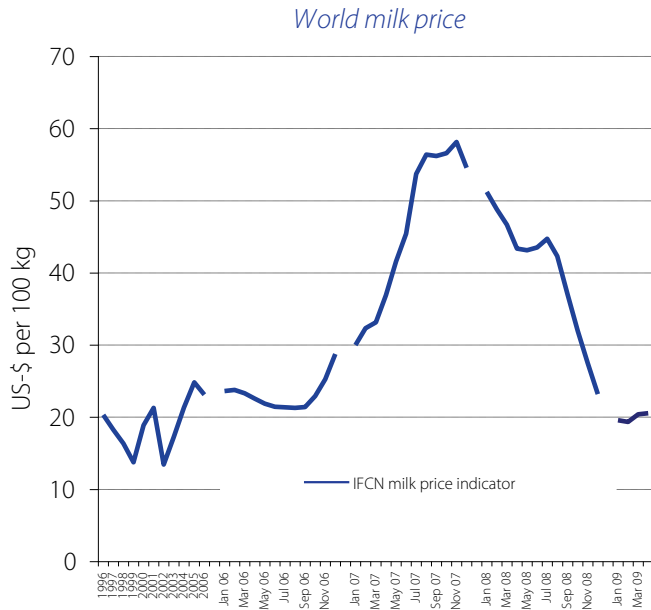
It is intentionally a brief overview of the situation and if you require clarification or would like to discuss any aspect of the document then we would welcome the opportunity to talk to you in more detail.

*"Although we face a volatile future, average profitability for good dairy farmers will improve in the medium term compared to recent years."*



# The world market

The global economy is under pressure. Most developed countries are currently in recession and this looks set to continue until at least 2010. This economic decline impacts upon international trade and means that demand for dairy products will, to an extent, continue to be suppressed in the short term. Added to this, the economic backdrop has led to unprecedented currency valuation changes, which add volatility.



Source: IFCN, 2009

Yet the prospects for the future look good. Demand will increase fuelled by population growth and long-term growth in income. Earth Policy Institute / UN figures suggest the net growth in world population is 76 million people per year. Put another way, by 2050 we'll share the planet with 2.5 billion more people than today – an increase of 38%.

And globally we are already seeing the start of agflation - increased food prices driven by tight supply and increasing demand on a world scale. Indeed, the Financial Times has talked of this - "The world faces an unprecedented period of food price inflation. Prices have soared as the expanding bio fuels industry, climate change and the growing prosperity of nations such as India and China push up the costs of farm commodities." And, despite the short-term volatility in the marketplace, the long-term prediction stands scrutiny.

Against this positive backdrop, price volatility looks set to stay and milk could become the most volatile agricultural commodity because of the relatively small proportion of overall production that is traded internationally.

Global milk production is currently around 700m tonnes per annum. But with only 45m tonnes traded internationally, this means that 94% is consumed on domestic markets.

Since EU reform in 2003, world stocks now drive markets even though the level of these stocks is small in world terms. Table 1 sets out what happened to stocks over the past five years, based on data provided by IFCN, a European economic unit based in Germany with whom Kite is linked.

Table 1: World dairy stocks in million tonnes

	2003	2004	2005	2006	2007	2008 (estimated)
Stocks	6.4	6.4	4.7	2.0	0	0
Change in stocks	0	-1.7	-2.7	-2.0	0	+5 to +10
Year end stocks	6.4	4.7	2.0	0	0	+5 to +10

Source: IFCN, 2008

We can see that a fall in stocks of 2m tonnes (0.3% of world output) during 2006 resulted in a doubling of world prices in 2007 and an estimated rise of 5 -10m tonnes (around 1% of world output) resulted in the recent collapse and halving of world prices. We are now well and truly on a roller coaster.

*"World stocks levels will be a primary influence on world market prices moving forward."*

A key point for the future is that markets will turn and prices will rise. The question is when?

To remove the current stocks could take 2-3 years based on recent demand – supply balances. But the level of volatility we now see could exaggerate the slow down in supply since prices have fallen so far and providing that world demand does not collapse (a risk if recession were to turn into depression) then we could see prices turn quickly.

So how well placed are markets to withstand this volatility?





# The European market

European producers are not used to volatility and are seeing large price reductions as shown below.

*Table 2 : EU farmgate milk prices (pence per litre)*

Country	October 2008	April 2009 (estimated)	% change
Italy	32.0	29.7	-7
Sweden	29.3	24.3	-17
France	27.5	21.6	-21
Germany	26.5	21.8	-18
Netherlands	29.7	23.8	-20
UK	27.0	23.8	-12
Poland	21.8	18.0	-18

*Source : DGAgri 2009*

In our view, EU production will reduce significantly, with evidence already emerging that production is dropping (e.g. French milk production has reduced by more than 6% year on year).

This has much to do with the relatively high cost of production in the EU (average 30ppl cash cost), which is now significantly higher than the milk price across much of Europe.

In an attempt to stabilise the EU dairy market, the European Union has recently recommenced export refunds and opened intervention stores. This demonstrates recognition from them that there are likely to be difficulties with the dairy markets in the months ahead. It is currently too early to tell what impact this move will have going forward, although one area of concern for the medium term is that when intervention stocks are high, EU prices tend to stay low, as the EU will always take the opportunity to clear stocks, resulting in a 'hangover' effect in the market.

# The GB and UK market

But what of our own market? In Great Britain we now appear to be in a relatively good position compared to other countries. We have an island population of 60m and growing - 99 per cent of whom regularly consume milk and dairy products. This means we have a strong and loyal consumer base for our products.

We have also had more than ten years of painful re-structuring following de-regulation, which has resulted in our industry experiencing some of the lowest prices in Western Europe. Our industry has contracted by ten per cent in the last five years and this has tightened supplies, especially in the autumn. The threat to volume has brought about action to secure supplies from some retailers through dedicated supply chains, creating more order in the market.

But the tough conditions and contracting supply base have also exposed vulnerable businesses in the increasingly competitive processing sector, as evidenced by the recent failure of Dairy Farmers of Britain, the impact of which is still unfolding.

Our farmers have also been through some very tough times and this means we are competitive against EU suppliers for producing level milk supplies and we have the advantage that quota costs are all but eliminated.

So, because we have now got an industry focused on a well-structured domestic market with less reliance on commodities, then we should expect some insulation from falling prices. Furthermore, the ongoing weakness of Sterling on currency markets gives us some protection from the vagaries of volatile world commodity prices at the current time, although major changes in the value of Sterling or the Euro could, of course, equally work against us, and the downside of the current position is that it does lead to higher prices for some inputs.

But some caution is required. Milk production reached a 40 year low in the last milk year (2008/9) and farmer confidence remains fragile.

*“The UK dairy industry is ahead of the game in terms of restructuring. There is the opportunity to stabilise production in the years ahead, if farmers have the confidence to invest and grow their businesses, as the heifers are in the pipeline.”*

As a result of falling domestic production, last year fresh raw milk was imported into GB, primarily from Northern Ireland, to balance our tight supplies during the autumn trough and this has continued to some extent through the spring, undermining our milk prices on the secondary markets. We expect that with increasing volatility in world markets the Northern Irish will try to become more integrated into a total UK and EU market rather than focus on relying on world markets. Because they produce milk all year round, albeit with a significant spring peak, this is feasible and we could see further structural change in the GB market should this happen. And why not import milk from further afield? Well, we believe that this is not a realistic option for the future. Whilst Southern Ireland and France are potentially close enough to make imports of fresh raw milk a reality, there are no established supply chain relationships in place. In the case of Southern Ireland, production is also highly seasonal. In addition, the costs associated with transporting raw milk from our continental neighbours (somewhere between 3 and 7 ppl), allied with the lack of GB provenance and issues of product quality make it unfeasible.

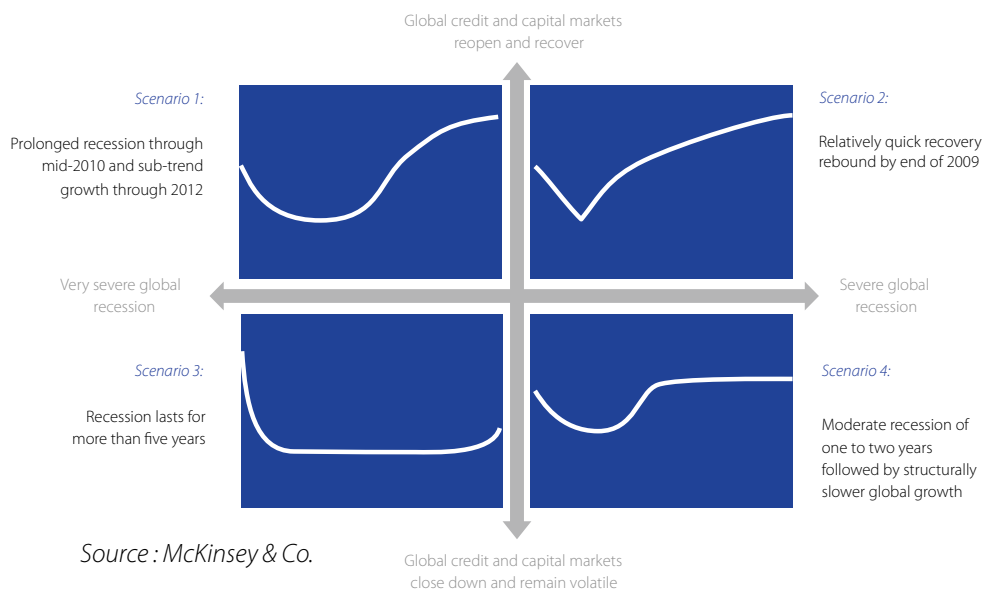
Could finished product be imported to replace GB produced fresh milk? Again, in our view this is unlikely as our continental neighbours do not have the processing infrastructure to support large volumes of pasteurised milk production, and GB consumers have a clear preference for fresh rather than UHT milk.

Looking at the cheese market gives a slightly different picture. The Southern Irish are active players in the GB cheddar market when world prices are low and when the €/£ exchange rate is in their favour, in effect increasing the effective total UK milk production to some 18.5bn litres and disrupting UK prices by flooding the market with cheap cheese. Yet, when world prices start to climb or €/£ exchange rates move against them, they rapidly withdraw cheese from sale in the UK and sell on international markets. In this way we can consider the Southern Irish a ‘lightning conductor’ to the world market but this activity causes huge disruption to our markets in the meantime.

The logo for Kite, featuring the word "Kite" in a stylized, handwritten blue font.

# The wider economy (and its impact on world milk prices)

Whilst there remains considerable speculation about the scale and pace of economic recovery, there seems to be consensus that the current global recession will not be long lasting. Analyst models suggest there are a number of potential outcomes:



Of course, commentators have different views on the likelihood of each of these scenarios but there is growing agreement that scenarios 2 and 3 are the least likely. Ultimately, scenario 1 (the 'U' shaped recovery) and scenario 4 (the 'P' shaped recovery) both suggest that the global economy will turn and head towards growth at some point between now and mid-2010, with a slower growth pattern thereafter than we have seen in the years immediately before the current economic turmoil.

Although the global 'green shoots' may not have been reached quite yet, there is some evidence to suggest that world dairy prices are recovering, although the future looks certain to be volatile. World whole milk powder prices reached a low of around \$1900 US/ tonne in February 2009, a level close to US support prices, and have increased since then with May 2009 prices reaching around \$2150/ tonne, suggesting that government intervention in building dairy stocks may have helped to arrest the further decline in world milk prices. Evidence from the global milk auction held by New Zealand co-operative, Fonterra, however, shows that whilst prices showed some recovery they are hugely volatile month to month. Fonterra's auction price reached a high of \$2235 US/tonne in April 2009 (a 21% increase from February 2009) but prices in its June auction dropped back to \$1886 US/tonne (a 16% fall). Despite this, the FAO suggests in its June 2009 Food Outlook report that "there is evidence to suggest that, based on fundamental indicators such as stagnant milk production in major exporters, prices may rise in the next few months". IFCN suggest that there is a lag of some 2-6 months between world markets and farmer milk prices, which could see further reductions in the near future before the farmgate price starts to strengthen.

However, as we have already touched upon, dairy prices are a factor of supply, demand and stock levels. With supply across the EU under pressure, and the prospect of overhanging EU intervention stocks being released on to world markets once prices start to firm, the future looks certain to be volatile.

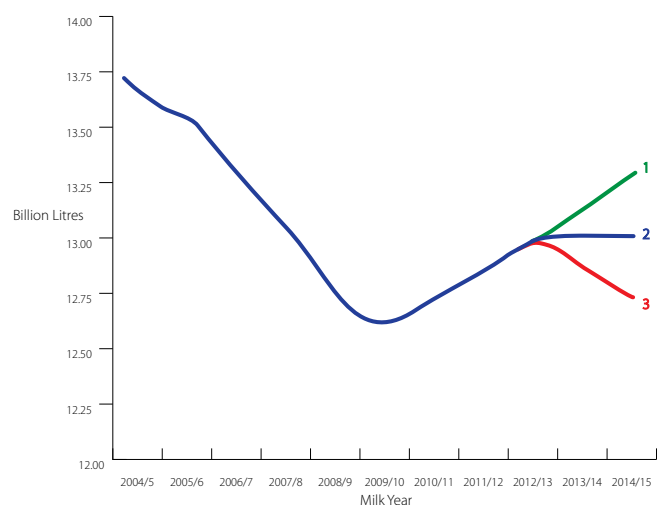




# Milk production forecast - UK

In our 2008 report we arrived at various assumptions for the structural change to the dairy industry over the period 2008 -2013. Due to the increasingly volatile environment, we have now updated our key predictions and suggest three potential scenarios for UK milk production in the years ahead:

## 3 Scenarios for UK Production



*“The current market dynamics will widen profit differentials - the rewards for efficient, flexible businesses will be greater whilst inefficient businesses will be exposed and more likely to fail.”*

These predictions on the future level of milk production are affected by many factors:

	Scenario 1	Scenario 2	Scenario 3
Farmer confidence	Improving	Average	Declining
Profitability	Good	Average	Poor
Pressure factors (e.g. legislation, disease risks, increased animal health and animal welfare requirements)	No major new ones	Steady	Major new ones emerging
Annual milk yield per cow change	+0.75% or more	+0.25 – 0.75%	0.25% or less
National herd size	Growing	Stable	Falling
Opportunities for alternative income	Poor	Average	Good
Weather	Good	Average	Poor

# Analysis

It is our belief that milk production will increase through 2011-2013 as a result of an increase in cow numbers, because additional heifers will come into the industry following higher dairy inseminations in the last two years. This accounts for the increase in production we have shown on the graph, although more recently we have seen the a reduction in dairy inseminations as farmers switch back to beef inseminations following higher beef prices.

In addition, we believe that milk yields will continue to increase as a result of improving fertility through the increased use of new technology such as Heatime and RMS. But we predict a slowing in the rate of growth compared to our previous assumptions (2008: +1%/yr.) as a result of lower feed rates in response to volatile milk prices and the increasing prevalence of cross breeds in the national herd.

What is less clear is the rate of retirement from milk production. Whilst milk prices improved briefly last year, the recent decline in farmgate prices, combined with concerns over the constraints imposed as part of the NVZ regulations and the recent high profile demise of Dairy Farmers of Britain, has led to diminished confidence among farmers, despite the apparent turnaround in global prices.

Our view is that we will see a lag in improvements to UK farmgate prices of between 6-12 months caused by the 'hangover' effect in the EU as intervention stocks are released on to an improving world market. But we believe that prices will increase and that we are not returning to the days of poor returns that we have previously experienced.

The UK dairy industry is ahead of the game in terms of restructuring and our analysis shows the opportunity to stabilise production in the years ahead, if farmers have the confidence to invest and grow their businesses, as the stock are in the pipeline. We therefore remain confident for the future of good farm businesses but believe that there is a need for the supply chain to work more closely together in the face of volatility, building mutual trust and improving confidence.

In a volatile market there is a danger that power will yo-yo from farmer to processor as market dynamics alter. Because of the long-term nature of the industry, farmers value stability and there is strong evidence from the supply chain that where arrangements have been established to provide stability, farmers have invested in their businesses and are more committed to long term dairy production. We believe there are more opportunities for this kind of approach to be successful.



# Conclusion

There is inevitably a great deal of uncertainty at present and in such a situation it is very difficult to accurately predict market developments.

But from our analysis, we believe that the most likely outcome for the global economy is that we will follow a 'U' or 'P' shaped recovery over the next 12-24 months. This, coupled to continuing population growth, will lead to an increased rate of demand for dairy products, providing a strong foundation for the UK dairy industry moving forward.

We are confident that the market will turn. Indeed, there is growing evidence to suggest that global dairy markets have now bottomed out and, assuming that we are at the bottom of a 'U' or 'P' shaped curve, we would expect that world prices will rise again in the near term (within 6-12 months).

Whilst there will be a lag factor in EU farmgate pricing caused by the hangover of EU intervention stocks being released on to the world market, this would suggest that farmer returns will improve moving forward and we would expect EU farmgate prices to show recovery within 12-18 months.

It is our assessment therefore that, although we face a volatile future, profitability for good dairy farmers will improve in the medium term compared to recent years. And, despite the pressures associated with NVZ legislation and the constraints it imposes on the use of land area, we believe that there is still an opportunity for strong farm businesses to prosper moving forward as long as they are competitive, efficient and able to adapt to change. This is what our clients are working towards.

Equally, we believe that weak businesses will find it hard to survive in these unpredictable times and as US business guru, Warren Buffett, says "It is only when the tide goes out that you learn who has been swimming naked." The current market dynamics will widen profit differentials - the rewards for efficient, flexible businesses will be greater whilst inefficient businesses will be exposed and more likely to fail. This applies equally to farmers and processors, as evidenced by the recent demise of Dairy Farmers of Britain.

At a farm level, we believe that to be well positioned for the future a dairy farm business must:

- Be technically proficient
- Have a competitive cost of production for their market
- Engage with the supply chain
- Understand and have the ability to manage volatility

So, whilst the future is almost certainly volatile and change will be a constant companion, there is cause for optimism among progressive farmers like Kite's client base. In the UK we have strong consumer demand for our products and we are ahead of much of our near competition in terms of restructuring. We have many opportunities and, as an industry, we must seize them.

For the first time in many years, the building blocks are in place for us to stabilise our industry. Increased dairy inseminations will bring additional heifers to the national herd, providing the opportunity to reverse the previous downward production trend. Continuing volatility will drive further structural change in the wider industry and provide opportunities for strong businesses that can manage that volatility to build from a profitable base.

But everyone needs to be confident about the future and we must recognise the value of closer links within the supply chain. This has particularly come to the fore in recent months with the benefits of strong supplier relationships between responsible retailers and farmers, with pricing based on more transparency and reflecting the cost of production, bringing some stability in an otherwise chaotic market. To give farmers confidence in the future they must trust their trading partners in the supply chain and initiatives such as these can only help to build that trust through more open dialogue.

In our previous reports we have likened the dairy industry to a super tanker that is heading for the rocks and will be slow to turn around. We believe that the tanker may now be turning and we are confident that those who can adapt are well placed to not only survive but also prosper.

*"Trust and confidence throughout the supply chain is vital. Customers must ask themselves what they are doing to build trust and encourage stability."*





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