

ANDERSONS Dairy Outlook

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Converting Higher Prices into Profit

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INTRODUCTION

This time last year we wrote that some cautious optimism was returning to the dairy sector. This was based on higher prices on global milk commodity markets gradually finding their way back to the UK dairy farmer. Whilst milk prices did indeed go up, rapidly escalating costs have largely absorbed any price increases. The industry remains in a fragile state, as highlighted by recent DairyCo research.

PRICES

The rolling 12-month average of the DEFRA farmgate milk prices stood at 25.85ppl at the end of June. This compares with 24.0ppl in June 2010 - a rise of 1.85ppl or 8%. This may look sizeable, but prices paid to British dairy farmers have been very slow to react to booming world markets.

The recent low point in the rolling milk price was in April 2010, since then, farmgate values have risen by 9%. Over the same period, the Actual Milk Price Equivalent (AMPE) has increased by over 30%. AMPE measures the returns from butter and milk powder commodity markets.

Global milk markets have experienced a bull run in prices since mid-2009, reaching a high point earlier this year. Markets have recently been weakening, but supply and demand fundamentals suggest that values should remain at historically good levels for at least the remainder of this year. Thereafter a note of caution should be sounded, as the current high prices will encourage increased production around the world. Demand will need to continue to grow strongly to absorb the extra output.

We forecast that UK farmgate prices will continue to rise over the next 12-months - even if only to catch up with what has already happened on commodity markets. The worry would be if manufacturing markets fall before this happens, or there is a major strengthening of the Pound.

Conventional wisdom has held that the UK dairy market is fortunate that over half of all milk produced goes into the 'high-value' liquid market. Recently, however, it has been manufacturing contracts that have led price increases and effectively forced liquid values up as price premiums have been narrowed to unsustainable levels.

The liquid market undoubtedly does smooth-out some of the price volatility seen for manufacturing milk. But there is a growing perception that liquid prices are far quicker to follow markets down than they are to track them up. Hence the interest in adopting pricing mechanisms that simply track the commodity market. This would trade-off a degree

of certainty for the prospect of better returns over the long-run. This illustrates that the UK dairy supply chain is still 'dysfunctional'.

The price rises seen over the past year would have been enough to ensure reasonable profitability but for the massive cost inflation seen - this issue is picked up in the 'profitability' section below.

POLICY

The discussions on the next reform of the CAP continue at EU level. Negotiations may well continue for two more years, and it is clear that a reformed CAP will be introduced for 2014 at the earliest. This will mean a roll-over of the current system for a minimum of an extra year.

Of course things may change, but the indications so far are that this will *not* be a radical reform of the CAP - the Single Payment (SP) will continue in some form after 2013. However, there will be 'tweaks' to the current direct payment system requiring farmers to undertake more environmental work to receive their SP.

Funding is likely to fall, although it seems that the SPS may not be cut by as much as once thought. Even so, Andersons' believe that its value could fall by a third by 2020, with all UK countries having moved to a flat rate per hectare system similar to England's. *The question for all dairy businesses is how they plan to replace lost SPS income.*

PRODUCTION

Despite the disappointing pace of price increases, one of the features of the 2010/11 milk year was the turnaround in output levels. Production was almost 4% up on the year earlier, and reversed a seven-year downwards trend. This is perhaps even more surprising as the conditions during the year were not especially benign for milk production.

Output is no longer increasing and it seems likely that volumes in the current milk year will be below that seen last year. A further group of producers are likely to leave the industry before the end of the year due to the imminent introduction of the NVZ storage regulations. It seems likely that those committed to the sector will increase production by enough to offset these losses faced with current levels of returns.

PROFITABILITY

The table shows the latest profitability figures from Andersons' Friesian Farm model. This is a notional 150 cow busi-

ness in the Midlands with a non-aligned liquid milk contract. Three years' figures are shown - the previous, current and future milk years.

FRIESIAN FARM BUDGETS - ppl	10/11 Result	11/12 Est.	12/13 Budget
Milk Price	25.8	28.6	29.3
Total Output	28.3	31.0	31.7
Variable Costs	12.9	13.9	13.3
Overheads	10.7	11.2	11.4
Rent, Finance & Drawings	5.1	5.3	5.4
Total Cost of Production	28.8	30.5	30.1
Margin from Production	(0.4)	0.6	1.6
Single Payment and ELS	2.4	2.4	2.4
Business Margin	2.0	3.0	4.0

Increasing costs and stagnant milk prices meant Friesian Farm had a difficult 2010/11- losing money before support payments (2009/10 also produced a negative margin from production).

As indicated above, milk prices are forecast to continue rising so the average for the current year will be almost 3ppl higher. Unfortunately this will not translate directly into higher profits. Variable costs increase compared to last year. This is largely driven by rises in feed and fertiliser prices, but often overlooked is inflation in 'other' variable costs such as straw, vet & med, seed costs, and dairy consumables. In terms of overheads, fuel and electricity contribute to the cost increases. The farm has also had to replace its main tractor this year – adding to machinery depreciation. Wage costs also continue to rise as the farm has to pay a competitive rate for increasingly scarce herdsmen.

The net effect is a positive margin from production – but only at very low levels. Adding in the Single Payment and ELS this provides a return of 3ppl. Based on the capital employed in this business (including the owned property), the return on capital is around 2.5%. This is obviously too low for long-term sustainability.

Looking to the future, it is believed that milk prices may increase a little more for the 2012/13 year. There is some hope that costs could abate for next milk year, albeit marginally. Fuel and fertiliser values may not reduce, but feed costs should fall. There are already signs that cereals markets are weakening. Profitability is therefore predicted to increase compared to the current 2011/12 year.

PERFORMANCE

Friesian Farm is just one business, and every dairy farm will perform differently. In fact, the gap between businesses is widening. Although the dairy supply chain needs to recognise that higher prices need to be paid if milk supply is to be maintained, at the same time dairy farmers can do a great deal to help themselves through increasing their business efficiency.

A successful dairy enterprise starts with operating a system that fits in with the characteristics of the farm (and its owner) and also the milk contract the business is supplying. Further, it is about ensuring the capital employed is consistent with the output of the business. Once the right system is in place it needs to be run effectively, including tight cost control and attention to detail. With the current high price of all inputs there is an increased focus on producing milk from grazed grass; the cheapest way to feed cows.

An increasing trend within the sector is for joint venture arrangements. These not only produce cost savings, but allow structural change within the industry – allowing the best businesses to grow and, whilst also offering an exit to those who wish to cease day-to-day dairying. It is often difficult to know where to start when setting up a collaboration. Andersons have been helping farmers implement and manage joint venture arrangements since the 1970's.

HELPING YOUR BUSINESS

The economic environment for dairy businesses undoubtedly remains challenging. However, higher milk prices do provide the opportunity to make better profits as long as costs can be controlled. The best dairy businesses continue to make good returns. There is no hidden secret and the majority of UK dairy farmers should be aspiring to the performance levels currently enjoyed by the top 20% of producers. Andersons can help dairy farmers make the right decisions to move their businesses forward.

We also look forward to working with all businesses in the dairy supply chain to improve the efficiency of the sector and secure long-term profitability.

Please contact us for an initial visit without charge or obligation to discuss the cost effective assistance that we can provide.

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Melton Mowbray
The Andersons Centre
Tel: 01664 503 200

Brecon
The Andersons Centre
Tel: 01874 625 856

www.theandersonscentre.co.uk

York
Andersons Northern
Tel: 0303 313 0001

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Tel: 01968 678 465

www.andersonsnorthern.co.uk

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Uppingham
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