DAIRY OUTLOOK

2010

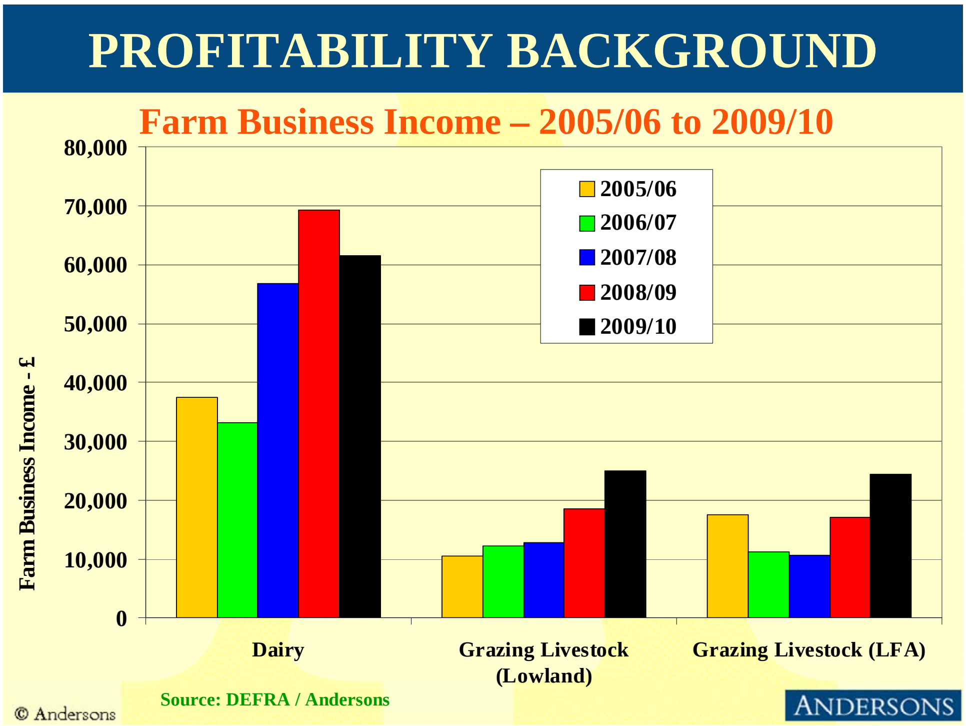
# *ANDERSONS DAIRY AND LIVESTOCK OUTLOOK*

*August 2010*

ANDERSONS
the FARM business CONSULTANTS

Andersons Dairy and Livestock Outlook is produced to coincide with the RABDF **Dairy Event and Livestock Show 2010**. It provides a copy of the boards displayed on the Andersons stand, as well as providing much more background information. For those that cannot make the show, we hope that the Dairy and Livestock Outlook also works as a stand-alone publication that gives the reader an insight into the current issues facing these sectors, and some of the ways Andersons can help those businesses involved in the industry.

## *PROFITABILITY BACKGROUND*

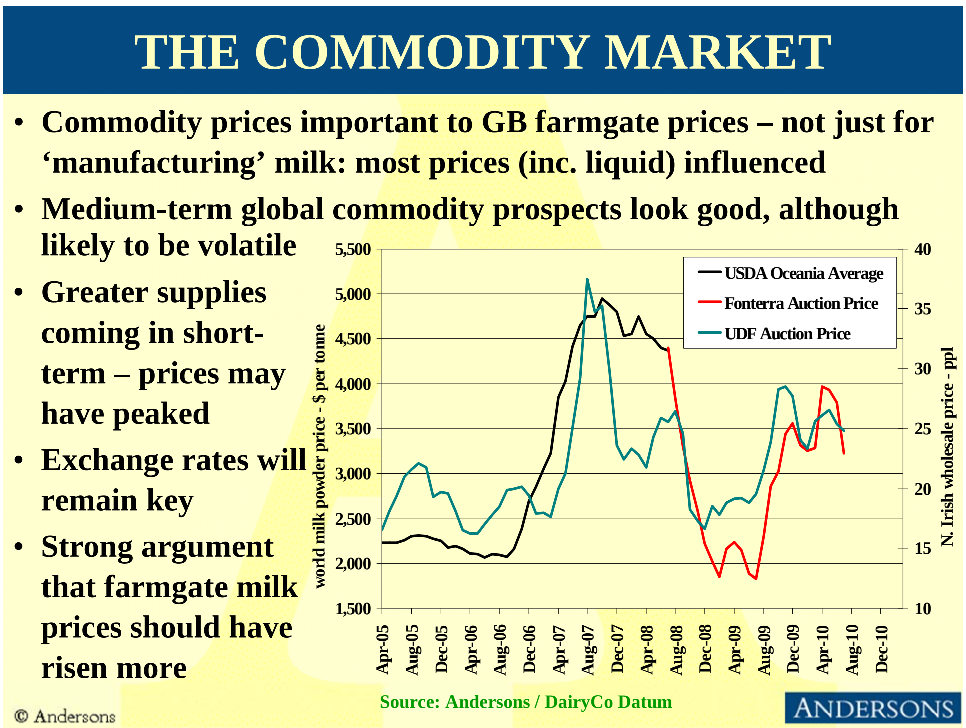



This chart is not shown on the stand, but provides some context for the current state of the dairy and livestock sectors. It shows data for farm-level profitability broken down by farm types. The figures are for England only and are averages for part and full-time farms (any business with over half a Standard Labour Unit requirement).

The measure used is Farm Business Income (FBI). This is DEFRA's preferred measure of farm income and can basically be thought of as the average profit for farms in the sector. More technically, FBI represents the return to all unpaid labour, management and capital invested. Some farm diversification activities are also included within the figures.

It can be seen that profitability in all the grazing livestock sectors has improved over the last five years. Much of this has to do with the weakening of the Pound, which started in mid 2007. Although it has tended to increase costs (see later), it has increased revenue. This is because if the Pound weakens against the Euro (and also to some extent the Dollar) it makes our agricultural goods relatively more competitive on European (and global) markets. Also, support under the Single Payment Scheme is set in Euros. As Sterling weakens, the value in Pound terms of this support rises to UK farmers.

## *MILK MARKETS AND PRICES*




Any optimism in the dairy sector stems largely from the recent increases in milk prices. To a large extent this is the result of a recovery in global milk product values, assisted by a favourable exchange rate. This chart show the Fonterra auction price. The sales from the New Zealand processor are widely regarded as the 'world price'. What is shown is the average price for milk powders. As liquid milk can neither be stored nor traded it is the price of such manufactured milk 'commodities' that feeds back in to the liquid market. As well as powders (skim and whole-milk), butter and commodity cheeses like cheddar are globally traded commodities.

There has been massive volatility in commodity prices over the last 3 or 4 years. The 2007-08 price surge was swiftly followed by a fall in prices. This was due to additional supply being encouraged by the high prices, coupled with lower demand thanks to the global economic slowdown.

Since last autumn, dairy markets have staged a strong recovery. Again market forces have been at work: global milk output was restricted by the low prices on offer. Also demand recovered as economic growth rebounded. There are currently signs that global markets may have peaked: although demand is still strong, there is greater supply coming forward, and consumers' demands are currently being met.

It is no easier to forecast the future of milk commodity markets than any other market in such unpredictable times. In fact, milk product prices have a tendency to be more volatile than many goods. This is partly due to the long production cycles in dairying. As the time taken to get a calf bred and through into milk production is measured in years, the industry cannot quickly respond to demand changes. Output tends to under or over-shoot demand. Another factor is that the vast majority of milk is still consumed in the country where it is produced. Only around 15% of global milk output is traded, although it is this trade that sets the price for all milk. With a relatively shallow market, values can move erratically.

There is some hope that milk values may have moved to a fundamentally higher level than prior to 2007. Certainly, long-term the demand fundamentals look good. As consumers in the developing world become richer they tend to increase the protein in their diets, and this includes milk and milk products. But this does not means that world markets will not undergo periods of low prices. Perhaps all that can be confidently forecast is that prices will be volatile. As in other parts of the world, the UK dairy sector must have robust businesses that can survive the hard times to prosper when markets are good.

The situation on the world market is mirrored closer to home in the auction values achieved by the United Dairy Farmers co-operative in Northern Ireland (also shown on the chart). This demonstrates the effect of global market forces on the UK milk market. In the UK, the effect of currency has been key in keeping our milk prices up. Any significant strengthening of the Pound against both the Euro and Dollar would pressure prices.

Even if global markets and currency were to turn unfavourable, there is no reason why UK farmgate prices should react. Prices paid to farmers have been very 'sticky' on the way up: only a small proportion of commodity market increases have filtered down to producer level. There still appears to be plenty of margin left, part of which could reasonably be expected to find its way to farmers. This is looked at on the next board.

## WHERE'S THE CREAM?

- **Liquid milk market accounts for 51% of UK production**
- **Average UK butterfat = 3.97% (12 months to June 2010)**
- **Average fat content of retail milk = approx 1.95%**
- **Excess butterfat sold as cream**
- **Cream price risen by 49% year-on-year**
- **Changes in cream market *alone* should have added approx 0.8ppl to liquid milk price**
- **Retailer supply groups have helped create greater confidence in supply-chain**
- **Will this be robust if supermarket milk 'price wars' restart?**
- **Has UK production decline really ended? Higher % of retail price may have to go to producers**

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With over half of the UK's milk production going into the liquid market, it can be argued that commodity prices should not be as influential as they are. However, there is an expectation that liquid contracts should deliver a 'premium' above commodity values. This can conflict with the cost-plus pricing model (e.g. the Tesco 'tracker') if costs are falling at the same time as market prices are rising. But, even pure liquid processors are linked into the commodity markets through their cream sales.

As an example, rises in the value of this 'waste' portion of the milk over the past 12 months are worth the equivalent of 0.8ppl. This is based on an the average July-June wholesale price of cream being £1,280 per tonne in 2009/10 compared to £860 in 2008/09. Using volumes of milk supplied plus the difference between the fat content in farmgate and retail milk, it is possible to convert this price increase into a pence per litre basis. Not necessarily all of this should have been returned to farmers, but it seems there has not yet been an equitable distribution of the increases across the supply chain.

It is easy to criticise processors and retailers, but the dedicated supply pools that have been set up have instilled confidence in some parts of the UK production base.

One worry is that retailers may increasingly use milk as a weapon in their 'price wars', with the cuts eventually finding their way back down to farm level. Fierce competition on the middle ground market (petrol stations, small stores etc.) is already blamed for depressing prices

*Andersons work with a number of dairy processing companies to help them manage their milk supply and farmer relations. Please contact us for more information.*

# *POLICY*

## FUTURE SUPPORT

- **Would your farm be profitable with half your current Single Payment?**
- **SP could be reduced to £100-£110/ Ha (£40-£45/acre) by 2020**
- **Current payments 'safe' until 2012, but EU Budget Review could see big changes thereafter**
- **Most farm support via CAP, so UK spending cuts should not affect SP directly**
  - **but budgets tight across Europe – less money for CAP post-2013?**
  - **UK 'match-funds' environmental schemes – less in the pot in future?**
  - **may pay to apply sooner rather than later for ELS and HLS**
  - **shift of costs onto the industry?**

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There is much talk of a new 'age of austerity' in the UK, as the coalition administration grapples with the massive budget deficit. All aspects of Government spending will come under review. In the short-term, the farming sector will probably get off relatively lightly. Most aid is prescribed by the EU under the Common Agricultural Policy (CAP). Of this, the biggest element is the Single Payment (SP), and funding for this is secure until at least 2012.

However, the current EU support structure is due for another reform, to be implemented for the 2013 SP year. With money tight across Europe, the budget for the next 7-year period to 2020 may well reduce. There could also be a redistribution of aid: between countries, policies, and individual farm businesses.

The signs are that the SP will be retained through to 2020, but Andersons believe that, by then its value could be halved compared to the current payment level in England. Could you remain profitable at today's milk prices with half of your current SP? This should be seen as a key indicator of long-term business sustainability.

In other parts of the UK, there will almost certainly have to be a move away from the current historic system to a flat-rate per hectare system similar to England's. This could see even greater falls in 'per Ha' payment levels.

*These reforms will fall within the lifespan of many rental agreements, and certainly with the useful life of many capital investments. Therefore the effects on the farm business need to be considered now. Realistically, income lost from the Single Payment will either have to be replaced by higher market prices (can this be relied on?), or efficiency improvements within the business. Andersons can help you address these issues. Those trading with farmers need to consider how the likely structural changes will affect* their *businesses*

One part of the CAP that could be under threat is the Rural Development money that funds programmes such as agri-environment schemes and diversification grants. This is part-funded by the EU, and partly by the Treasury. Rural development programmes will be expected to contribute to overall government savings, and the Treasury is looking to cut its contribution. Existing agreements already in place, whether ELS, HLS or capital grants should not be affected by any of these cuts. However, new agreements may be hard to come by. For those thinking about applying under any of the Rural Development programmes it may pay to get in sooner rather than later.

*Andersons' consultants can assist farmers and landowners making applications under agri-environmental schemes. They can also advise on capital grants under the RDPE and equivalent schemes in Wales & Scotland.*

One effect of the austerity measures may be a culling of the many agencies agriculture deals with. Whilst many might regard this as a positive, it may leave an administrative vacuum which is detrimental to farming. For example, it has already been announced that the English Regional Development Agencies (RDAs) are to be closed. It is not clear what this will mean for the RDPE grants they administer.

The requirement to save money may see proposals for disease cost-sharing move up the agenda. This might be accepted by the industry if it were part of a larger package that included positive action on TB control (including a badger cull). However, with the recent court challenge to the Welsh trial cull, all UK administrations are likely to be wary of moving on this issue.

One area that should be safe from spending cuts is the schemes to support renewable energy production. This is not simply because of the Government's green agenda, but because it is energy users rather than the government that pays for policies such as feed-in tariffs. It means that this new area of potential revenue for farmers should continue to provide good opportunities.

*Although the renewables sector provides huge potential benefits for land-based businesses, it is a relatively new field. There are many technologies, and a variety of scales of operation. Farmers need to choose what is right for their particular circumstances. Andersons can offer a completely independent view. Crucially, our business experience means that we are well-placed to judge the financial and not just the technical feasibility of renewable projects*

# DAIRY PROFITABILITY FORECAST

## FRIESIAN FARM MODEL

- **150 cows averaging 7,500 litres on 100 Ha (part rented).**
- **Year-round calving, liquid contract. Owner + worker.**

| *ppl* | 2009/10① | 2010/11② | 2011/12③ |
|---|---|---|---|
| **Milk** | **24.8** | **26.1** | **26.8** |
| **Total Output** | **27.2** | **28.6** | **29.1** |
| **Variable Costs** | **11.8** | **12.3** | **11.4** |
| **Overheads** | **10.5** | **10.6** | **10.9** |
| **Rent, Finance & Drawings** | **5.0** | **5.0** | **5.2** |
| **Total Costs of Production** | **27.3** | **27.9** | **27.5** |
| **Margin From Production** | **(0.1)** | **0.7** | **1.6** |
| **Single Payment and ELS** | **2.6** | **2.4** | **2.3** |
| **Business Surplus** | **2.5** | **3.5** | **3.9** |

 Source: Andersons ① Result ② Estimated ③ Budget ANDERSONS

To illustrate the profitability trends in dairying, Andersons have a 'model' farm: Friesian Farm, is a notional 100 hectare holding in the Midlands running 150 cows. It has a liquid milk contract.

The table shows the farm's performance for the previous 2009/10 milk year, based on actual returns and costs. An estimate is given for the current 2010/11 year, and a budget for 2011/12.

For 2009/10 the business dipped into negative returns from production (both the previous years had produced a positive margin from production of around 1.7-1.8ppl). This was primarily due to the fall in milk prices. However, costs rose too – fertiliser prices were high, and overheads went up for the 2009/10 year as Friesian Farm invested £80,000 in water separation and slurry storage to comply with NVZ regulations: adding to the cost of production through depreciation and higher interest charges.

Looking at the current 2010/11 year, recent price rises, with hopefully more to follow, should help achieve an average price for Friesian Farm 1.3ppl higher than last year. Remember that Friesian Farm is on a liquid contract and is assumed to get a premium over the average DEFRA farmgate price (of around 1ppl on average). Variable costs will be higher in the current year compared to last. The issue of concentrate feed costs are looked at in more detail later. In terms of winter forage, Friesian Farm, has budgeted for higher feed usage to offset the effects of this summer's drought on silage stocks. However, it is assumed that the farm has reasonable amounts in the clamp - some farms in the 'real-world' will be far worse off, and consequently see much bigger cost rises. The price of straw is also an issue this year. Some relief comes from an offsetting fall in fertiliser prices.

The net effect of all these changes is that Friesian Farm should deliver a positive margin from production in 2010/11. The farm has been in the ELS and is planning to renew its agreement for a further 5 years. The Single Payment is budgeted to fall somewhat due to a stronger Pound than last September. This support, when added to the margin from production, produces a reasonably healthy return.

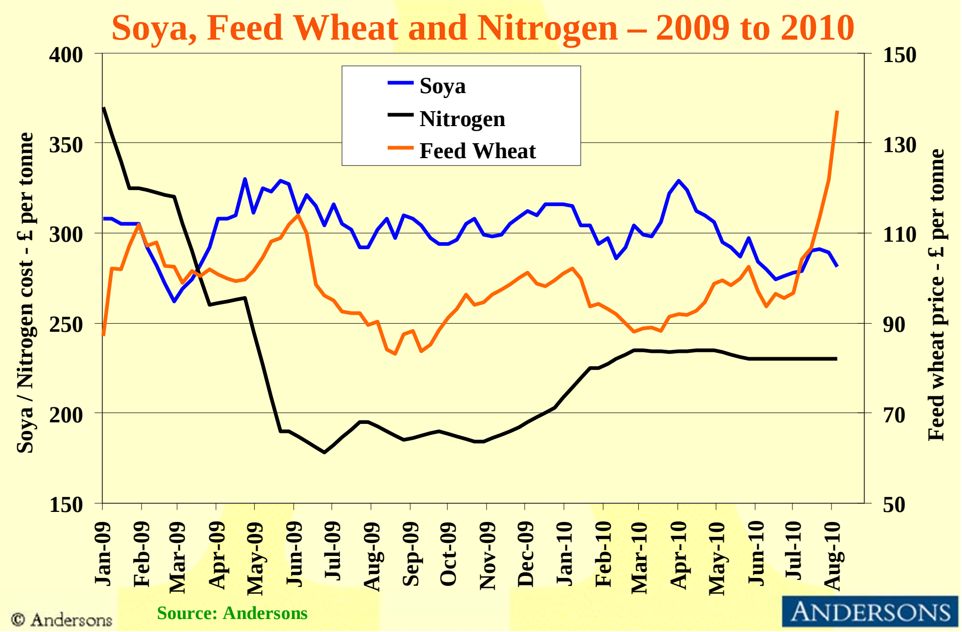
Looking to the future, it is believed the yearly average milk price may strengthen further for the 2011/12 year (dependent on currency). If 2011/12 is a more 'normal' weather year, then variable costs should fall as the extra feed requirements disappear. But we may see Base Rates starting to increase, which pushes up the farm's financing charges. Overall though, profitability is predicted to increase compared to the current 2010/11 year. However, a margin of around 4ppl still only represents a 3.7% return on capital for Friesian Farm. Would other parts of the dairy supply chain accept such low returns?

We are often asked about some of the key variables within our Farm Models. This table gives some background data on how the Friesian Farm figures were arrived at.

It needs to be remembered that these values are specific to Friesian Farm. It is designed to give a flavour of the profitability in the sector - it cannot represent every dairy farm, nor is it designed to show 'best practice'. Many costs (e.g. fertiliser) are very dependent on when they are purchased.

| **FRIESIAN FARM** | **2009/10** | **2010/11** | **2011/12** |
|---|---|---|---|
| Cull price- ppkg lw | 88 | 95 | 90 |
| SP conversion rate – p per € | 90.93 | 85 | 85 |
| Dairy concentrate - £ per tonne | 180 | 200 | 185 |
| Nitrogen - £ per tonne | 285 | 225 | 235 |
| Diesel price - p per litre | 44 | 52 | 55 |
| Base rates - % | 0.5 | 0.5 | 2.0 |

# INPUT COSTS




This chart is another one not shown on the stand. It is here to illustrate some of the cost issues dairy farmers are facing.

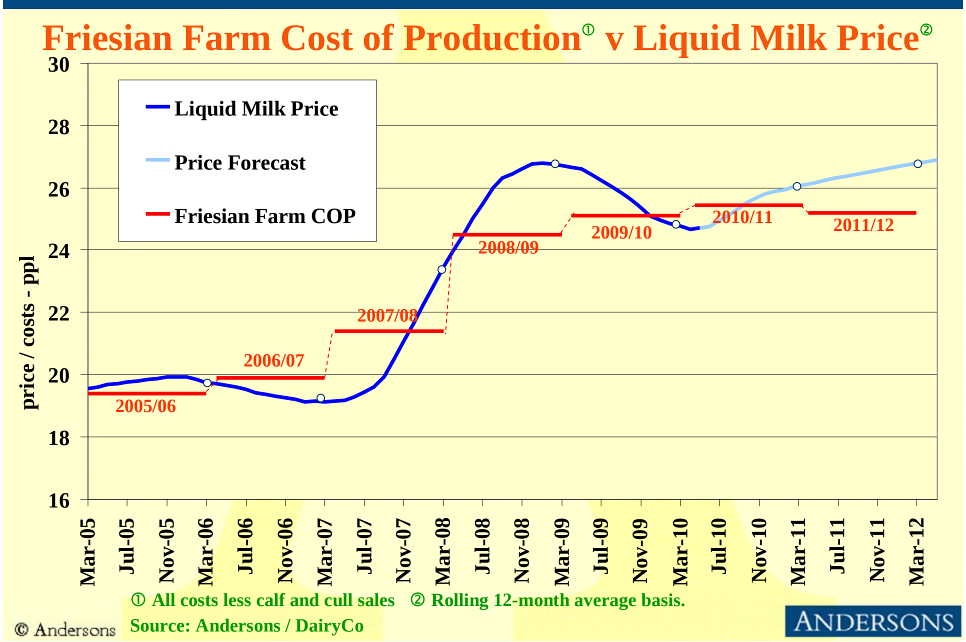
Firstly, on fertiliser, values have now firmed compared with where they were a year ago. Although there are yearly fluctuations, it seems that prices have moved to a higher level than seen prior to be 2007 'spike'. For many years Nitrogen prices were around the £100 per tonne mark. The shift in the £/€ rate is partly responsible, but also changes in the world fertiliser market have had an effect.

It should be remembered that Phosphate and Potash prices have seen equal, if not greater, rises.

The feed wheat and soya price is shown as cereals and proteins are the major components of compound feed diets. It was widely believed over the last 6 months that the soya price might fall. However, it has remained stubbornly high, with only a small reduction in price. The feed wheat price had seemingly settled into a range just above £100 per tonne, but prices have jumped massively in the run-up to harvest 2010. This is largely due to a series of weather-related crop problems reported in some of the main grain growing areas of the world.

It is not at all clear whether there is any actual shortage of grain, or whether markets have been driven more by perception and speculation. Even if recent price rises prove to be a bubble, they are likely to affect future feed prices as feed compounders will have had to have taken 'cover' at the prevailing higher prices. When we first ran the Friesian Farm model in late July, variable costs were only 11.9ppl. They are now up to 12.3ppl (see previous page) simply on the basis of likely higher winter feed costs.

# MILK PRICE & PRODUCTION COSTS




This shows graphically our predictions on milk prices. What is shown is the 12-month rolling average which smooths out the monthly price fluctuations. It is based on past DEFRA data with a Friesian Farm liquid supplement.

Also plotted in the average Friesian Farm cost of production for each milk year. (After the sales from culls and calves has been deducted). This shows the big step-up in costs over the last few years which does not look set to reverse.

As the price is a 12-month average, the point at the end of the year is the average for that year (indicated by the dots). By comparing this with the cost of production, it is possible to see the yearly profit.

*Andersons work with some of the best UK dairy businesses. We can help your business improve its profitability by comparing its performance and identifying areas for improvement. We can also assist in helping you plan for the long-term future of your business, be it investment appraisals, growth opportunities, joint-ventures, or succession and retirement planning.*

# THE LIVESTOCK SECTOR

## LIVESTOCK PROFITABILITY

- **154 Ha mixed lowland farm (114 Ha owned, 40 Ha on FBT)**
- **Beef (suckler cows, and finishers) sheep and arable**
- **Proprietor, 1 FT family worker + casual**

| ***£ per Ha*** | **2009/10①** | **2010/11②** | **2011/12③** |
|---|---|---|---|
| **Livestock Gross Margin** | **478** | **431** | **455** |
| **Crop Gross Margin** | **123** | **188** | **170** |
| **Total Gross Margin** | **601** | **619** | **625** |
| **Overheads** | **460** | **451** | **477** |
| **Rent, Finance & Drawings** | **301** | **298** | **302** |
| **Margin From Production** | **(159)** | **(130)** | **(153)** |
| **Single Payment and ELS** | **264** | **252** | **253** |
| **Business Surplus** | **105** | **122** | **101** |


**Source: Andersons** ① Result ② Estimated ③ Budget

As it is the Dairy Event *and* Livestock Show, we have also looked at the profitability of livestock enterprises (and beef values are also important to dairy farmers).

To do this Andersons have another farm model. 'Meadow Farm' is a notional 154 hectare (380 acre) beef and sheep holding in the Midlands. The farm is part owned and part rented. It consists mostly of grassland, with some wheat and barley also grown for livestock feed. There is a 60 cow suckler herd with all progeny being finished, a dairy bull beef enterprise and a 500 ewe breeding flock. The business is technically efficient, but is only average in terms of cost control.

Meadow Farm's margin from production in the current 2010/11 financial year is set to improve but is still significantly loss making. The farm will only achieve a business surplus once the Single Payment and agri-environment receipts are accounted for, although the surplus is likely to be 16% up on 2009/10. The business surplus would have been greater if it were not for the recent weakening of the Euro against Sterling which is likely to result in a smaller 2010 Single Payment.

Variable costs for the business will be nearly 14% higher for the livestock enterprises for the coming winter 2010/11 as a result of increased feed, straw and forage costs. Miscellaneous variable costs (tags, veterinary and medicines, minerals, plastics, string etc) are often underestimated when costing livestock systems and make up a significant proportion of Meadow Farm's total livestock enterprise costs, particularly in the sheep enterprise.

Looking further ahead, the business is set to benefit from the forecast continued robustness of the lamb price and the anticipated rise in farm gate beef prices in 2011/12. However, despite a likely plateau in enterprise variable costs in 2011/12, the business' overheads are forecast to rise as a result of a planned machine replacement. The effect of this is a £36 per hectare rise in overhead costs in the form of depreciation, showing how sensitive the business is to a one-off investment.

The cost of production for Meadow Farm's livestock enterprises in 2010/11 are shown in the table to the right. The business achieves lower costs of production than many other similar businesses due to the reasonably high output of the enterprises in terms of calf and lamb numbers and subsequent carcase yields. The cost of production figures are highly sensitive to the total 'meat yield' of the enterprise in question.

| **MEADOW FARM: 2010/11 COST OF PRODUCTION** | **Cost of Production** ppkg/dw | **Target Sale Price** ppkg/dw | **Target Sale Price** £ per head |
|---|---|---|---|
| Finished Suckler Beef | 260 | 291 | 962 |
| Finished Dairy Bull Beef | 331 | 370 | 981 |
| Finished Lambs | 303 | 339 | 70 |

A target sale price is also shown in the table. This includes a 12% return for management. Businesses not only need a sale price that covers their costs of production, but also gives the proprietors a reward for their entrenprenuership.

Meadow Farm is typical of many medium sized, mixed family farming businesses. The proprietors continue to invest heavily in their businesses, both in terms of capital employed and the labour and management time demanded. The general increased optimism in light of tightening beef and lamb supplies and increased market returns is therefore welcome to many producers. This however masks the underlying issues facing many businesses; namely an unsustainable overhead cost base. Where businesses have livestock systems that best suit their farm and are able to run their enterprises in a cost conscious manner, sustainable margins are being realised.

Through its regional businesses Andersons are leaders in independent business consultancy in UK agriculture. For more details on the topics covered in this publication your local contacts are: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