Royal Bank of Scotland

Agricultural Services

Dairy Outlook
October 2015

The financial conditions within the dairy sector remain difficult. With milk production increasing in the first half of the year, combined with the extension of the Russian import ban and weaker demand from China, milk prices have weakened further. The average price received by producers in Great Britain decreased by 25.3% in the year to June, to 23.66ppl. There is some compensation in the form of flat feed costs, as a result of grain prices remaining low. 'Futures markets' suggest cereal prices will remain lower for the next year, but these markets remain volatile. Fertiliser prices are also more stable. However, these benefits are far outweighed by the substantial drop in milk price.

The number of dairy farmers continues to fall, with a reduction of 3.6% recorded in the past year, taking total numbers to 9,777 in England and Wales (DairyCo, July 2015).

In the final milk quota year, UK production increased by 5.2% to 14,394 million litres, before butterfat adjustments. This is the highest level of production for over a decade and reflects the pattern of production seen in all the major milk producing countries in the past year. With the quota system now at an end, it remains to be seen whether the current weakness in the market will curb the anticipated growth in production.
Despite the fall in dairy farm numbers, the number of cows increased by 3.3% or 59,180 cows. Defra's June 2014 Survey showed an increase in cow numbers for the first time since 2005. In early 2014, milk prices were much firmer and with rising demand forecast, the mood in the sector was much more positive at that time. The number of female replacements over 24 months old also increased by 5.6% to 408,403 in the year to June 2014 - raising the possibility of further increases in cow numbers.

Subsequent results from the December 2014 survey confirm that there was further growth, with a 3.7% year-on-year increase being recorded in the size of the dairy herd at that point – despite the fact that markets were becoming oversupplied and prices had fallen significantly. In contrast the number of young stock appears to be moving in the opposite direction, with heifers in the 1-2 year age group falling marginally, by 0.1% (Defra). This may be an indication that the expansion in cow numbers may be about to go into reverse, as the financial pressure bites.

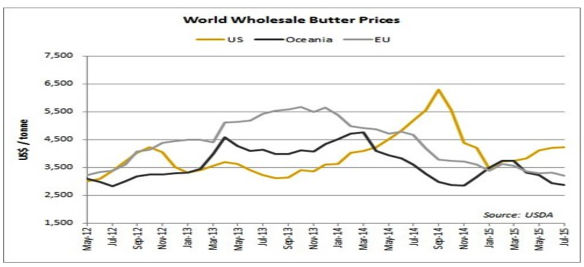
Against this background, a further increase in milk production in 2015/16 seems unlikely.

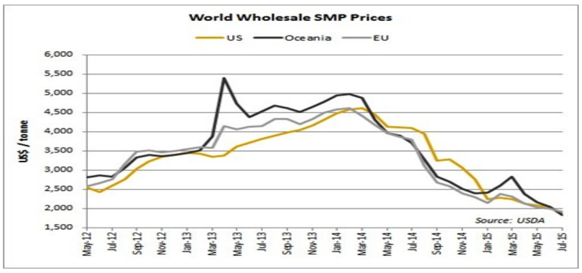
The UK market, although heavily dependent on liquid milk sales (51% of production goes into the liquid market), does not exist in isolation. Movements in world dairy markets will ultimately have an effect on UK markets – although there is sometimes a time delay for this to feed through.

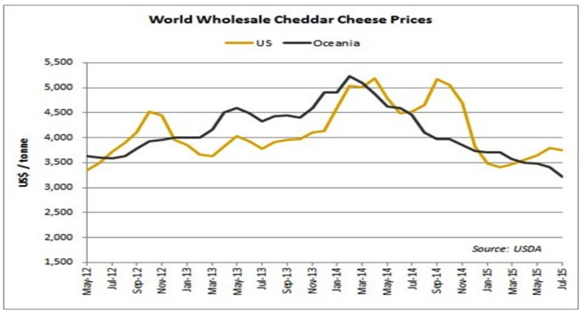
Approximately 5% of world dairy production is actually traded internationally. Relatively small movements in either supply or demand can have a significant impact on the traded balance, making this market particularly volatile. In addition, prices are influenced by fluctuating currency valuations and economic growth (especially in S.E. Asia). So, world prices remain unpredictable and volatile.

Global milk supply this year is forecast to increase on the 2014 level. New Zealand is the largest trader of dairy products, with production in 2014/15 increasing by 2.8% following a 9.3% increase a year earlier (DCANZ).
The US, another major trader, is currently forecast to increase production by 2.6% in 2014/15 (USDA), with production still rising. Although world demand is also likely to rise in the longer term, current demand is flat. Russia has extended its import ban on EU products for another year. Demand in China is weakening as their economy slows. As a result world dairy commodity prices have come under pressure and are likely to remain under pressure for the next six to nine months.

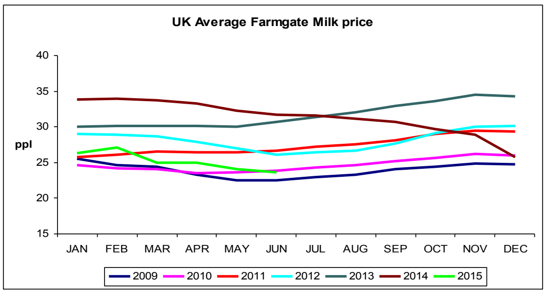
World dairy commodity prices have fallen back toward the levels seen three years ago. Butter (and fat based products in general) have seen the most dramatic fall (approximately 30% in the EU – although US prices have firmed in 2015 following their dramatic decline last autumn). The milk powder market has fallen significantly (down 50%) in all trading regions but cheese less so (with the US market actually rising in 2015, following last year's autumn decline).







Within the UK commodity market, prices have generally followed a similar pattern, with butter and cream down around 30% and powder prices down around 50% year on year. Cheese prices have been a little more stable, but mild cheddar is still down around 25%. Most UK commodity prices are now back to the levels seen three years ago. UK liquid milk prices have fallen on the back of the movements in commodity prices. UK farm-gate milk price movements very often lag behind those in world commodity markets.



Source: DairyCo

By the end of June the average UK price had fallen to 23.66ppl (Defra), which was 25% lower than a year earlier and its lowest point for five years.

The average milk price, however, only tells part of the story. The sector appears to be characterised by an increasing polarisation in price. Although all farm-gate prices have declined, farmers supplying 'supermarket contracts' have continued to benefit from premium milk prices, compared to those on standard contracts. Although higher costs may be incurred to obtain the best prices, this price differential will affect the level of profitability on individual farms.

Total cost of production is also a key contributor to profit. Finding the right balance between input use and milk output is essential in achieving profit. The control of fixed costs is especially important for small herds.

But efficient milk production is possible at almost any scale of production.

Good news for diary farmers comes as feed prices remain flat following lower grain and protein crop prices.

While these are likely to remain lower in the coming year, the global supply:demand balance in cereals remains relatively tight, so prices could move upwards after that.

The other important variable cost, which has moved significantly in the past, is fertiliser. Prices of phosphate and potash are relatively flat, probably in response to weaker demand. The reliance on gas in the production process of nitrogen fertiliser also means that the price of this element is likely to remain volatile. However, lower energy costs at present and increased urea production, are likely to put downward pressure on prices in the short term.

Fluctuating sterling values against the US dollar and the euro are also likely to influence input costs.

Managing input costs in this environment has an important role in determining farm profitability. However, in the current market, it is the low milk price which is having the biggest impact on profitability. Even the most efficient producers' margins are likely to be tight, when faced with current milk prices.

In the past dairy industry bodies, like DairyCo, have stressed that to increase profitability the industry should focus on three areas:

Efficiency - across the supply chain and compared with competitors.

Innovation - differentiate milk, increase its value and provide higher prices by better meeting customer needs.

Relationships/ contracts - in order to obtain both efficiency and innovation through the supply chain.

These three aspects don't provide a 'quick fix' - but they offer a longer term, more achievable and less painful solution to increasing profits, rather than forcing a reduction in milk production, or waiting for 'natural wastage' to increase milk prices. The industry is making progress on a number of these issues.

The challenges facing everyone involved in the milk sector highlight the importance of understanding the market place and meeting its requirements. For all parties to succeed in the future, it will be essential for both farmers and processors to work closer together, collaborating throughout the supply chain.

To see how we can help

0800 092 9116
(Minicom 0800 169 0088)

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