



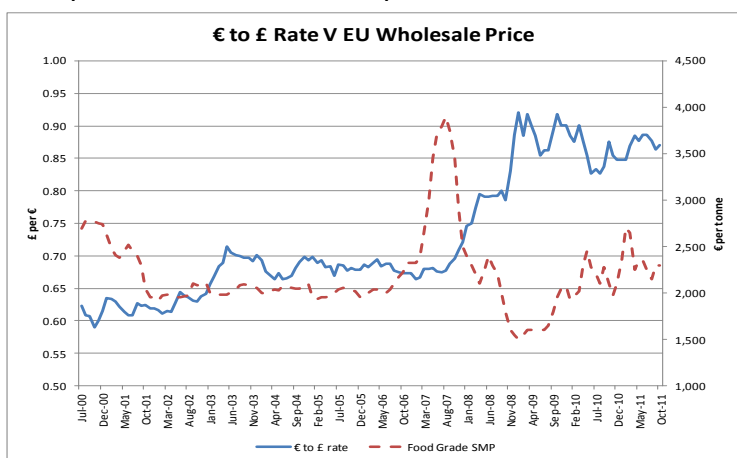
## Dairy Market Update

17 November 2011

Page 1 © AHDB

### Exchange rate volatile as Eurozone crisis continues

Last week (10/10/11), sterling reached its strongest level against the euro in eight months as concerns over the ongoing sovereign debt crisis in the Eurozone increased again. Concerns now focus on Italy, the Eurozone's third largest economy. The country is in the process of forming a caretaker government following the resignation of Prime Minister Silvio Berlusconi last week. Italian sovereign debt stands at €1.9 trillion, or 120 percent of economic output.



As shown in the chart above, fluctuating exchange rates have an effect on EU market prices. During 2007 and 2008, values for EU SMP fell as the euro appreciated against sterling. In contrast, as the euro weakened while the Eurozone crisis worsened, prices have improved as the Euro becomes more competitive.

### In context

From a trading perspective, a weaker euro means that UK exports will be less competitive than the EU equivalent. Continuing economic volatility may affect the market in other ways. Consumers with less disposable income may 'trade down' and buy cheaper variants. In order to limit their exposure processors will need to consider how they manage their product mix.

### Processors struggle to pass on higher costs

Half-year trading updates published by Dairy Crest and Robert Wiseman Dairies show just how difficult the market situation for liquid milk is. Dairy Crest reported an increase in operating profits (including exceptional items) of 4.7% to £46.8m for the half year to 30 September 2011. However, this was due to growing profits from its spreads and cheese segments. Profits from the dairies segment, (liquid milk, cream and milk powders), fell by 46.8% to £5.8m for the half year, including £4.6m profits achieved from property sales. Robert Wiseman Dairies' operating profits fell by 40.6% to £12.5m in the six months to 1 October 2011.

The reduction in profitability in the liquid milk market in the UK can be attributed to rising costs and challenging market conditions at the retail level. Rising costs of raw milk, fuel and resins have put processor margins under pressure. While it is common business practice to increase selling prices as costs increase, the current situation of declining consumer expenditure has meant that retailers are resistant to any price increases which would put them at a comparative disadvantage.

### In context

As suppliers of milk to major retailers, it appears Dairy Crest and Robert Wiseman Dairies have faced difficulties negotiating the price increases required to offset higher input costs. Both firms aim to gain operational efficiencies and may attempt to recover margins when market conditions improve.

### Global commodity prices remain stable

Global dairy prices continue to remain stable despite softer market dynamics which caused prices to weaken in the second half of 2011. The latest Fonterra auction results, for 15 November, show a modest recovery in prices and quantities sold across all product categories apart from Casein. This follows modest price falls seen in September and October. The all product average winning price rose by 2.6% over the previous auction on 1 November after a modest drop of 1.7% from the previous month.

Global financial analysts *Rabobank* report global supply running ahead of 2010 levels in all key regions. In particular, New Zealand has delivered persistently high volumes in milk output on the back of ideal grass growing conditions. The US and Europe have added to the global supply situation with more milk available for export due to weakening domestic demand.

Imports to China fell recently and a potential demand and supply imbalance has only been averted in the short-term as a result of continued strong demand from other key importing nations such as those in the south east Asian region. *Rabobank* predicts that stable global commodity prices will continue to the end of 2011. However, macroeconomic issues centred on the Eurozone crisis continue to weigh on market sentiment.

### Stronger taste and deals drive cheese market

Retail cheese sales increased by 5.2% in value to £2.56 billion in the 52 w/e 2 October with the average retail price per kilo of cheese increasing 2.9% to £6.17/kg. The volume of sales increased 2.2% to



## Dairy Market Update

17 November 2011

Page 2 © AHDB

228,974 tonnes. Cheddar sales, which account for 55% of the total volume, have grown by 2.4%, slightly more than the category as a whole.

Cheese by Sector	Volume (% change)	Value (% change)
	52w/e 2 Oct 11	52w/e 2 Oct 11
Total Cheese	2.2%	5.2%
Total Cheddar	2.4%	5.1%
-Mild Cheddar	-2.7%	-1.0%
-Medium Cheddar	16.4%	13.6%
-Mature Cheddar	0.8%	4.3%
-Extra mature Cheddar	12.3%	15.5%

Source: Kantar Worldpanel data 52 w/e 2 October 2011

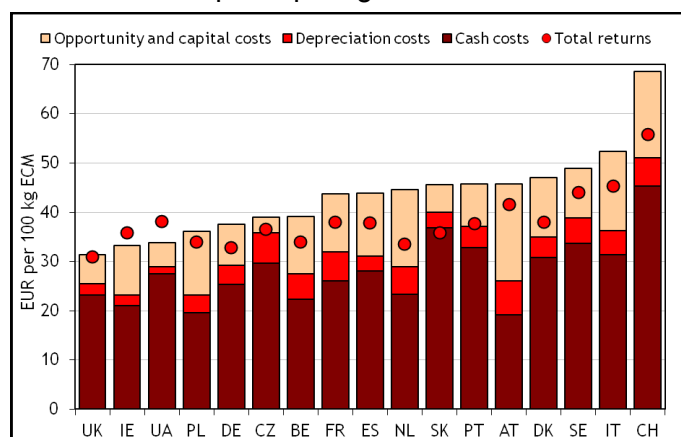
Consumers are trading up taste levels. Medium and Extra Mature Cheddar has shown strong volume and value growth at the expense of Mild and Mature Cheddar.

Extra Mature Cheddar has shown the most rapid growth and now represents 10% of the total cheese market in volume terms at 41,244 tonnes. The leading brands within this sector; McLelland Seriously Strong, Pilgrims Choice and Cathedral City collectively account for 58% share by volume.

Research conducted by Mintel has identified that 'special offers' (63%) and 'low price' (52%) were the top two factors consumers were most likely to look for when buying cheese with 57% of consumers stating they 'often buy whichever cheese is on offer'. Competing with price as a joint second factor, 52% of consumers said they looked for 'strong tasting' potentially explaining the recent growth trends in the Extra Mature Cheddar market and the contribution to value growth in the cheese market overall.

### UK has one of the lowest costs of production

International cost of production comparisons by two independent organisations show that UK dairy farmers achieve one of the lowest costs of milk production in Europe. The European Dairy Farmers (EDF) Cost of Production Comparison 2011 shows the average UK production cost at £27.8/100 kg to be the lowest of 19 participating countries.



Source: EDF Cost of Production Comparison 2011

The UK outperformed the EDF average in labour and capital productivity as well as average yield, at 7000 kg/cow. The UK average culling rate at 20% was the third lowest after Ireland and Switzerland.

The International Farm Comparison Network (IFCN) provides a representative comparison of world milk production systems, with 157 farm types across 49 countries. This ranks UK production costs as the second lowest in Western Europe after Ireland and below the world milk price of £26.8/100 kg. In the IFCN analysis, the UK outperformed the IFCN average in high labour productivity and lower building, labour, capital and feed costs.

Feed Prices (Range £/tonne)	Intensive energy rations	High protein concentrates	Exchange Rate €/£ (w/c 08/11/11)		UK Average Farmgate Milk Price: September								
			October 11		2011	28.03	2010	25.25					
October 11	235-248	338-347	0.85574										
Wholesale Prices and Market Indicators	IMPE	AMPE	MCVE (Milk for Cheese Value Equivalent)	Cream Income*	Butter (£/t)	SMP (£/t)	Mild Cheddar (£/t)	Bulk Cream (£/t)					
					October 11	18.8	32.8	32.59	9.01	3,500	2,150	2,925	1,580
					September 11	18.9	33.3	33.11	9.19	3,600	2,150	2,975	1,620
					September 10	19.0	29.7	29.67	8.28	3,250	1,950	2,750	1,500
Retail Prices	Liquid Milk (retail) (4 w/e 02/10/11)		Doorstep (4 w/e 02/10/11)		Butter (02/11/11) Branded (p/250g)		Mild Cheddar (02/11/11) Non-branded (p/kg)						
October 11	0.61		1.07		164		564						
% change v October 10	No change		6.0%		n/a		n/a						

\*Cream income = The cream income to a liquid processor is based on the value of the excess cream created because the average level of fat on liquid milk sold through the retail market (supermarkets, local stores and doorstep) is less than the level of fat in the raw milk they receive. It assumes all the cream is sold in bulk form.