



The big milk implosion

What does it mean for the Australian dairy market?

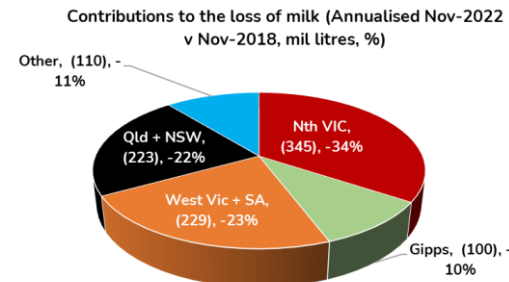
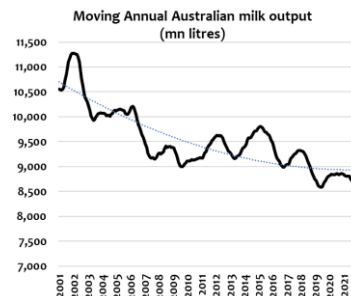
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Milk production is dropping like a stone

- Australian milk output has been falling since 2002 and in steep decline since late 2015.
- In the past 4 years, 1bn litres has been shed, more than a third lost from Nth Victoria and almost a quarter from Western Vic and SA.
- Next season, national milk production is likely to be back below 8bn litres, less than the output in the 1993/94 season.
- **Why is it falling so much?** This decline isn't simply about climate patterns – we've been in a La Nina event for more than two years but recorded some of the worst losses in good seasonal conditions. No longer is it driven by farmgate milk prices.
- The **major factors** driving **farm exits** and the **decline in milk** are:
 - Capital values of assets (land and cows) are attractive
 - Lack of ownership and management succession
 - Lack of farm labour
 - Dairy farming is more complex than alternative farm enterprise uses which more attractive returns

Can the decline be slowed and reversed?

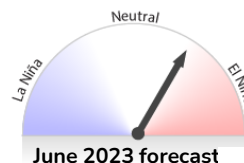
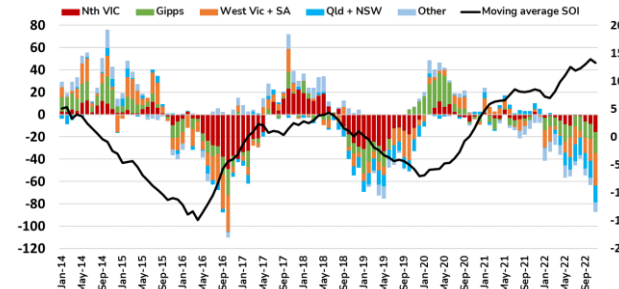
- **Short answer – not quickly.** It will take time before output steadies, but substantial reversal is less likely.
- In 2022/23 cows have continued to exit, which is yet to cycle through reported production. We now expect output will fall 3-4% next season.
- An **El Nino is forecast to develop later in 2023** which will make it more challenging to produce and source cheap feed.
- Heifer markets could become more inviting. China will continue to seek high-quality young stock to resource new facilities planned in the next few years. NZ will stop heifer live exports in 2023, creating more scope for Australian producers, and depleting the herd of young stock for growth.
- **Can output be steadied by a larger injection of capital and the involvement of corporate investors?** We are suddenly no longer in the era of cheap money, which will push up the investment hurdle rate (ROI) sought by capital investors.
- **Can Australian dairy farm operations** (whatever the investment model) **compete for capital** with these higher ROI targets in future? The cost base has risen but if milk prices remain elevated, the prospects for higher returns with skillful management are likely to have improved.



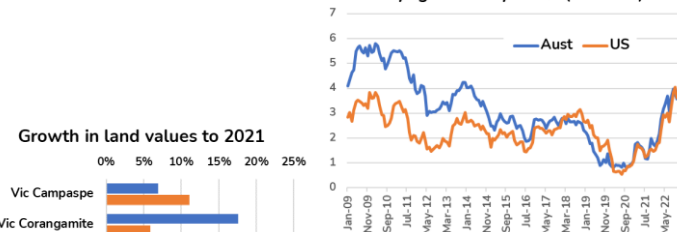
Comparing 2023(f) and 1994 seasons

		1994	2023
Milk	m litres	8,079	8,040
Farms		14,510	4,100
Cows	000	1,787	1,300
Production			
Drinking milk	m litres	1,845	2,367
Cheese	000t	227	436
SMP	000t	228	150
WMP	000t	114	26
Butter	000t	144	69

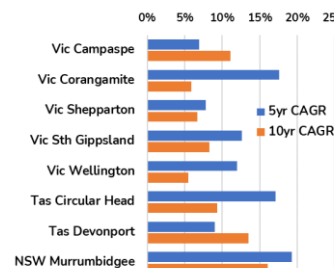
YOY growth in Australian milk production (m litres)



10yr gov' bond yield % (2009-23)



Growth in land values to 2021

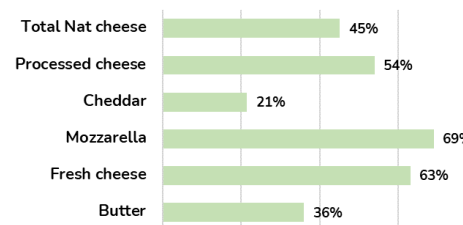


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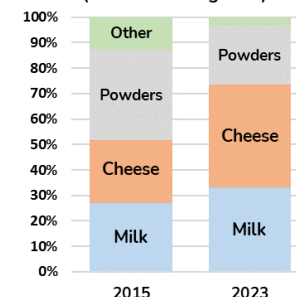
How will milk be used?

- With reducing milk supply, the product mix has and will continue to **sustain packaged milk and cheese output**, leaving less for milk powders and butter.
- Milk use will continue to prioritise higher value domestic markets – milk, cheese, cream, dairyfoods and specialised ingredients. This has been underpinned recently as higher domestic prices have been passed to consumers.
- Exports are declining but mostly be focused on higher value niches. We have lost traditional long-term markets to more agile and efficient competitors.
- Every litre of milk lost in fresh milk regions of Queensland and NSW comes out of the south and has intensified competition for milk there.
- **Will the world market matter in future?** The industry hasn't enjoyed immunity to date, and the reliance on imports will only increase as commodity cheese remains important for lower-value market segments, and the butter deficit worsens as fresh cream uses take priority. Longer dairy supply chains serviced by imports are more costly and riskier.
- Retailers will continue to use the world market as a benchmark. The history of cheese pricing shows the domestic market offers some stability. However NZ export benchmarks remain influential over time, while we currently see wide divergences over world prices for domestic cheese and butterfat with the quick fall in global markets.
- The world market will improve beyond the present imbalance and the divergence will narrow again. Looking longer, there is more pressure on milk production globally with limits on EU and NZ output. It will remain more volatile, but commodity values will continue to trend higher.

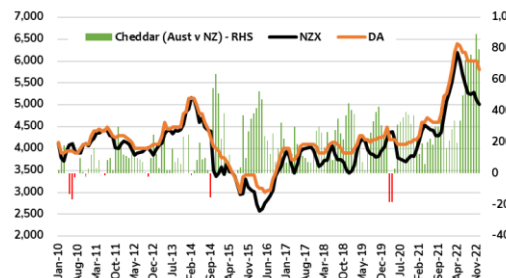
% of available product (production + imports) which was trade-exposed in 2021/22



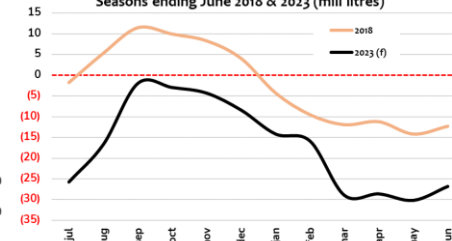
Change in milk use % (seasons ending June)



Cheddar spot price comparison (DA v NZX) \$US/t



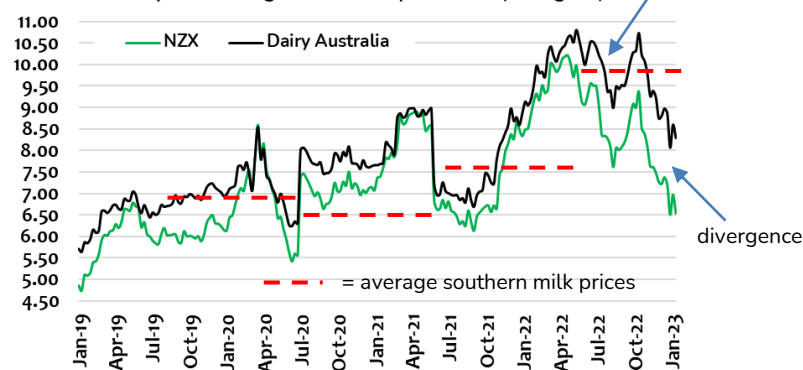
Monthly Qld-NSW milk shortage Seasons ending June 2018 & 2023 (mill litres)



How will milk be valued?

- When a **domestic market moves into deficit**, wholesale prices are valued at **import-parity**; when in surplus, export returns drive value.
- **Can processors continue to afford these farmgate milk prices?** If retail prices remain steady, that should be feasible, but in the short-term retailers will be sensitive to competition for foot traffic as consumers become more frugal in response to broad-based cost-of-living increases.
- **Will traditional milk pricing still work in the future?** Paying for spring milk gets harder unless there is a much greater focus on specialised ingredients.
- **Will the Code of Conduct help or hinder innovation in milk pricing?** Will there be incentives or punishments for processors in trying to be different? So far, in the 3 years since the Code came into play and competition has intensified, we have already seen some reduction in transparency.

Weekly CMV using NZ & Aust spot series (A\$/kgMS)



Milk Pricing Period

divergence

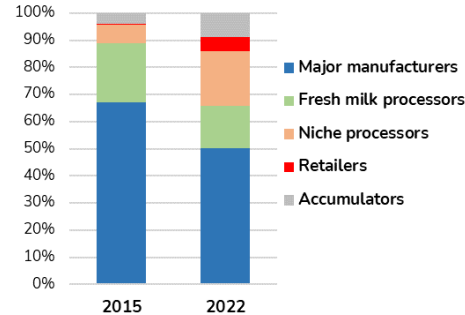
Who will win and who will pay

- The milk producer has so far been the winner as many milk buyers with ample capacity bid to keep their milk intakes and market commitments intact.
- **Has the consumer been the loser?** With milk in short supply, “import-parity” pricing has created a value-transfer from consumer to producer, with small gains for some but not all processors.
- Consumers are now paying more sustainable prices for fresh milk products, while cheese prices reflect a higher regard by retailers for security of supply.
- It is **far too early to assess the consumer response to elevated prices**. It is clear however that consumers regard dairy as an important dietary staple but pressure on household spending will see some damage to demand and some trading-down where possible.
- Retailers will protect themselves from losses of market share but aren’t expected to revert to pre-2022 discount pricing practices.
- **The major losers will be processors that can’t compete for milk** either through their exposure to commodity markets or their inability to adjust their business models to extract greater product value.

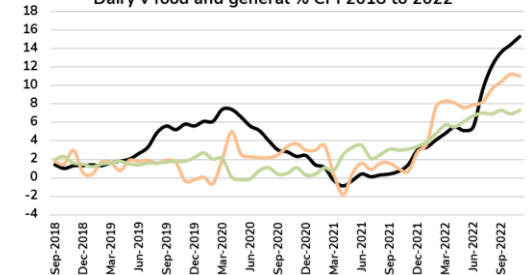
How will supply chains change?

- There will be more differentiated supply chains and greater security will be sought by end-users. These may include regional differences in supply chain requirements and advantages.
- Retailers will seek certainty of supply and, where possible, leverage their capacity/positioning to improve their attractiveness to producers.
- **Will competition for milk remain intense?** Milk is likely to continue to shrink, but so will some demand, as the scale of the milk losses will inevitably see plant capacity removed. Depending on manufacturing decisions and the quality of production seasons, **we may lurch between capacity surplus and supply tightness**.
- There is likely to be an **increased role for agile bulk milk accumulators** that work with their customers to match their evolving business requirements.
- **What will the asset fleet look like in future?** Manufacturers will quit exposures to commodity, while niche dairy foods processors will have to innovate to compete. Whether the industry remains relevant to the major global dairy brands will depend on plant capabilities to service higher value segments.
- **Milk producers can achieve better outcomes** suited to their risk and return appetite by fully understanding their market options and the requirements of their customer.

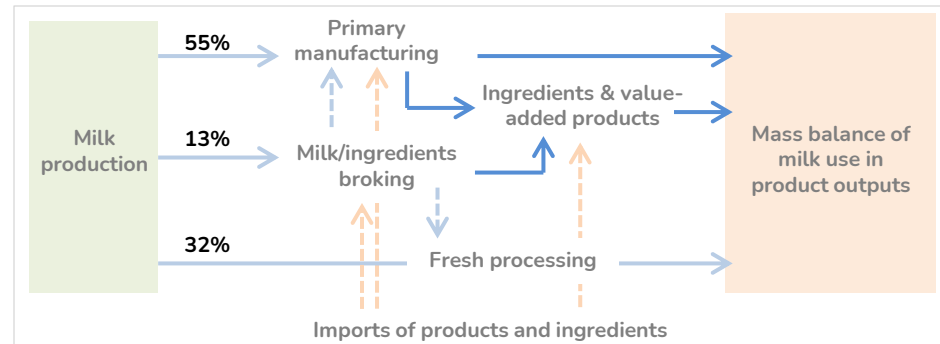
Changes in farmgate milk buyers (% of national milk intake, season ended June)



Dairy v food and general % CPI 2018 to 2022



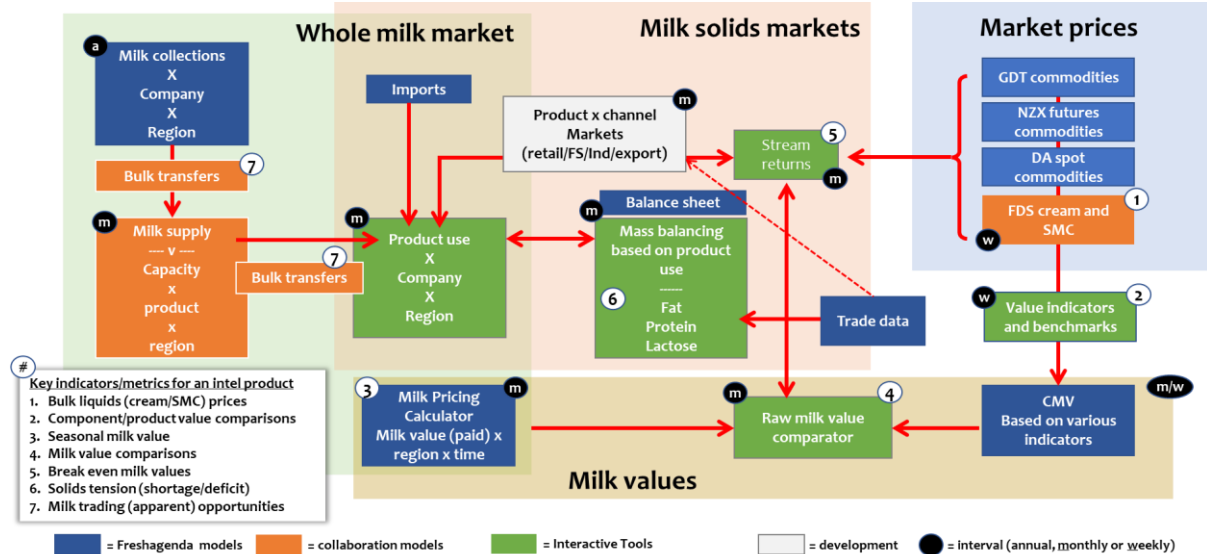
Raw milk use by major activity in 2021/22 season



Australian Dairy Insights platform

Freshagenda

- Freshagenda provides an ongoing analysis of global and domestic dairy market developments.
- Our global market analysis has been delivered to clients in Australian and overseas markets for a number of years using the Global Dairy Directions platform.
- The **Australian Dairy Insights Platform** extends this analysis capability into the domestic market to monitor:
 - Milk production trends (by company, region and end use)
 - Farmgate milk pricing analysis
 - Milk use based on manufacturing requirements according to a mass-balance analysis of available of milk solids
 - The influence of global commodity prices and fundamentals affecting the outlook for commodity markets
 - Wholesale cream and skim milk concentrate pricing
 - Australian import and export trends
 - Retail and food service trends
- The **Dairy Products Monthly** report monitors relevant trends and their implication for product and milk values.
- Our platform offers optional access to our **website portal** that tracks relevant pricing series as well as supply and demand factors.
- It also offers optional access to **interactive tools** that are used to derive some of the key insights which are updated through our cloud database facilities.



Australian market

Supply & demand

- The effects of extensive rainfall in most regions and flooding in Arid Victoria and Queensland will further depress the milking herd and cause a further reduction in the competition for milk in a normal pattern by the end of Q1-2023, with a lean season in the coming months, supply shifting.
- Regardless of the prospects for similar milk prices in FY2024, the complexity of production options, fluctuations in input costs, and the reduction of exit values for farm and dairy from production will further reduce cow numbers for the FY2024 season.
- There are slim chances of any recovery in cow numbers with the continuing demand from China through Victoria according to Dairy Australia, also to be split from the same week last year for feeders, especially with the ongoing end of NZ live exports in April 2023. Via normally and 1.8% above the 2-year average. There will be significant volumes of down-grade grain after harvest in FY2024, to take production to near 7.7bn litres.
- Feed grain prices continue at elevated levels but ended the year weakening below \$400/tn for feeders, especially with the ongoing end of NZ live exports in April 2023. Via normally and 1.8% above the 2-year average. There will be significant volumes of down-grade grain after harvest in FY2024, to take production to near 7.7bn litres.
- An acute shortage in further production will occur in Feb 2023 but this year the challenge product mix for the current season based on assumptions that developed milk sales will be 0.5% higher value than estimated 2022 output. The actual classification of SMP is likely to be higher value than in the industry trade data.
- Domestic demand in value is likely to be weaker. Feed retail sales lifted 5.0% in October, well below the rate of food inflation and suggestive of trading down. While C&F & restaurant sales include a recovery in cheese and packaged milk sales, which are showing an uptick in retail data. Overall continued to struggle on these publicised ABS numbers in food service sales with about 20% YOY after increasing 40% in 2022/23.
- Packaged milk EU/ET and EU/ET export sales have slowed in FY2023 and are now extended for fact about 20% YOY after increasing 40% in 2022/23.

**Our estimate there is an overstatement of SMP production and trade in official DA data reporting due to the inclusion of higher value SMP sales.*

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