



Dairy Situation and Outlook

February 2018

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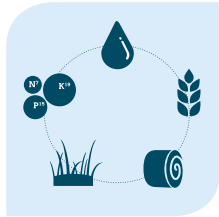
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Key
● Positive ■ Neutral ● Negative


Inputs



Situation: ■
 Outlook: ■

Spring was wetter than average across most of Australia and the BOM upgraded their ENSO outlook to La Niña. Demand for hay is low as steady rains continued to top up paddocks while grain prices increased when rain interrupted the harvest. Water trading was elevated and led to price increases but fertiliser prices are still subdued.

Global supply



Situation: ●
 Outlook: ■

Milk production in Europe has surged, putting renewed pressure on dairy commodity prices. Conversely, intakes in New Zealand have tracked below expectations so far, whilst the US shows a gently slowing rate of growth and Australia's year on year output fluctuates.


Global economy



Situation: ●
 Outlook: ●

Global economic output in 2017 grew 3.7%, 0.1% more than previously forecast, following unexpected upside in developed countries. The IMF predicts growth to increase to 3.9% in 2018 as the economy continues to recover. A boost is expected from the new US tax policy.

Australian market



Situation: ■
 Outlook: ■

The Australian domestic market remains largely stable, with positive volume growth in most major dairy categories. Sales value growth remains robust, with the exception of cheese where prices remain under pressure.

Global demand



Situation: ●
 Outlook: ■

Export demand remains steady, with export volumes up 2% in the last year. The total value of dairy exports increased almost 14%, reflecting improved global prices. Demand in China and Japan has improved, however other markets have been more subdued.

Exchange rates



Situation: ■
 Outlook: ■

The AUD remains strong against the USD however forecasts suggest it will depreciate in 2018. The NZD has also sustained a high value against the USD and the EURO/USD rate is the highest since 2015. The strength in other dairy exporters' currencies is limiting the impact on Australian competitiveness.

Executive summary

- › **Australian milk production is up 3% for the first half of the 2017/18 season as a result of improved weather in most regions, and incrementally higher milk prices.**
- › **Slower milk production in NZ and good import demand have helped support commodity prices in the short term, but the fundamentals point to significant downside risk for prices in the months ahead.**
- › **The Australian market remains stable, with volume growth in most major dairy categories. Sales value growth remains robust, with the exception of cheese.**

Having ended the 2017 calendar year on a distinctly bearish note, the global dairy market has stepped up a gear for the beginning of 2018, with six weeks of steady to higher prices across most commodities. This short term lift has created a sharp contrast with ongoing warnings of lower prices in the months ahead. Robust demand from key importers (particularly China and Japan) and a slow New Zealand season have supported prices, but are considered unlikely to outweigh the impact of year on year production growth through the northern hemisphere spring peak. Australia's dairy industry is not immune to these fundamental supply and demand pressures, but will also be subject to competitive tension between milk processors with additional capacity to fill from a supply base that has contracted 8% over the past two years.

In a sign of modest recovery, Australia's milk production is up nearly 3% for the first half of the 2017/18 season, reflecting a more favourable spring than 2016 in most regions, and incrementally higher milk prices. As envisaged in Dairy Australia's October Situation and Outlook report, this production growth is driven by southern, export-focused regions. Domestic-focused regions have seen profitability and (in some areas) seasonal challenges weigh on output. Given the weak 2016 comparables and continuing challenges on-farm, it's

likely that year-on-year growth rates will moderate during the second half of the season, with Dairy Australia's full season forecast remaining for growth in the range of 2 to 3%.

Amongst the key global dairy exporters, milk production has shown diverging trends. In Europe, milk volumes have surged. Growth in European milk production has been one of the key drivers in the deterioration of market sentiment since the northern hemisphere autumn. Year-on-year growth for the latest reported month (November) is at 6%, with the year-to-date total closing in on 2% for 2017, and likely to add another 1% (of 150 billion litres) in 2018.

In a positive sign, the size of the region's dairy herd has begun to fall, and combined with the decision to move straight to a tender-basis for government intervention buying, this should herald an eventual moderation in the current growth spurt.

US milk production continues to grow, up 1% in December, ending 2017 with an increase of 1.4% for the year (for a total of nearly 98 billion litres). The rate of growth peaked at 2.1% in August and has since slowed relatively consistently.

After wet and cold conditions muted the recovery from last year's slow spring, extremely dry conditions have further hit New Zealand's milk production

through the summer months. December 2017 milk intakes were around 2.5% lower than the same month in 2016, representing a change from the trend which had seen year on year growth peak at just over 4% in November. Rain in January may help arrest the decline, however there will be further impacts as a result of lower feed surpluses in spring reducing the volume stored as silage or hay.

Key global markets have helped absorb some of the increases in milk production, with China and Japan seeing double digit annual percentage increases. Whole milk powder and infant formula demand have grown strongly in China, whilst increased exports of whey powder, cream and SMP have also been noted. Industry commentary points to lower domestic production in China and the continued cost competitiveness of imported product, particularly from Australia and New Zealand. Imports of liquid milk from major exporters (except Australia) have fallen considerably over the same period, down 12% from 620,000 tonnes to around 546,000 tonnes, with much of this decrease appearing to have come from the European Union, and Germany in particular.

In the case of Japan, the largest single increase occurred in lactose, with SMP and cheese also seeing significant

Key to success will be the ability of processors to support and grow a profitable milk supply base to capture the full potential of their manufacturing footprint.

increases. Dairy trade volumes to southeast Asia have remained largely flat, as have those to Mexico. Despite continued uncertainty over the future of NAFTA, US exports continue to make up over 80% of Mexico's dairy imports. The EU and New Zealand are competing for second place in market share, with exports from both up significantly over the last five years.

Dairy trade with the Middle East and North Africa (MENA) region from the major exporters remains depressed, with particularly large falls in butter and WMP purchases likely reflecting the impact of significantly higher dairy fat values in especially price sensitive markets.

The Australian domestic market remains largely stable, with volume

growth continuing in most major dairy categories. Sales value growth is robust, with the exception of cheese where retail prices are still under pressure.

Key developments in the corporate sector include the sale of Murray Goulburn's assets to Saputo (pending ACCC and FIRB approval), and the sale of WA-based Brownes to a consortium of Chinese investors led by Shanghai Ground Food Tech. Northern Victoria has seen numerous facility investment announcements. Fonterra unveiled a \$165 million capital expenditure program intended to boost its processing capacity across its Australian operations, with the bulk of the spending aimed to increase the production of the newly rebuilt Stanhope cheese plant from 45,000 to

80,000 tonnes per annum. Australian Consolidated Milk (ACM) is building a new plant on a greenfield site at Girgarre, whilst former partner Freedom Foods is expanding the UHT plant at Shepparton that it now owns outright.

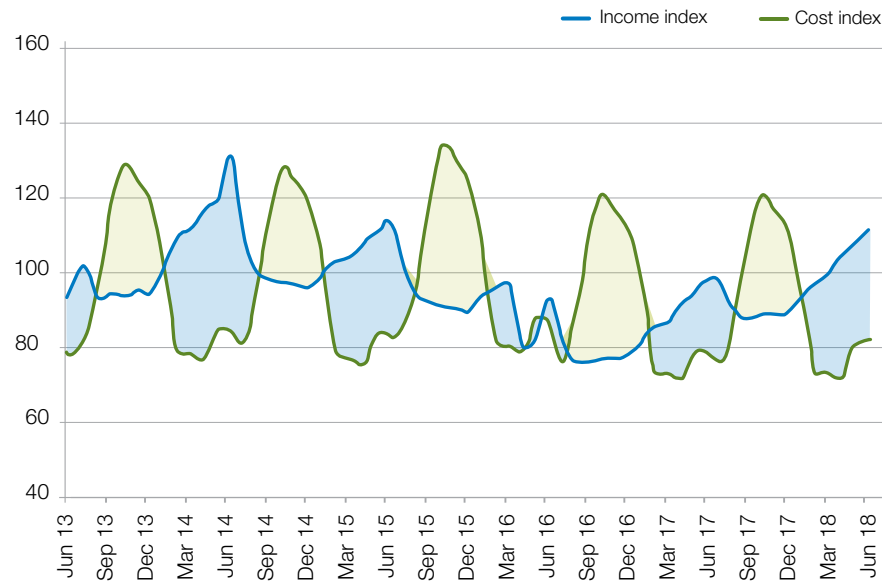
Such investments are encouraging signs of industry confidence, however key to ongoing success will be the ability of processors to support and grow a profitable milk supply base to capture the full potential these facilities offer. Amidst the contrasting short and medium term market signals, any inducement to produce more milk will need to account for the significant risks remaining in the global market.

Export region weighted cost and income indices

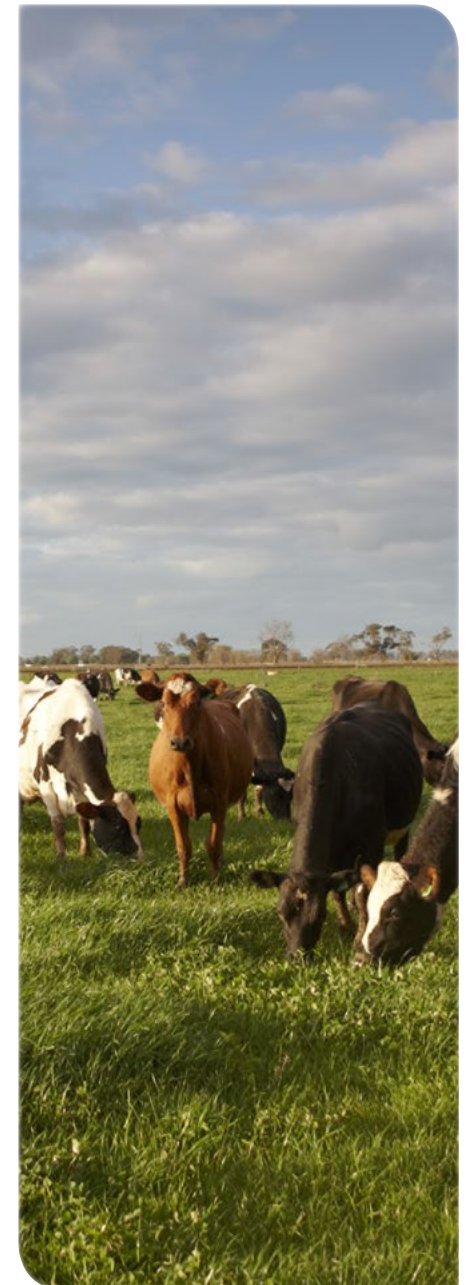
The weighted cost and income indices consider the near-term outlook and highlight the net impact of market changes. The latest update suggests:

- › As foreshadowed in previous reports, improved milk prices this season have boosted margins and will assist farmers to rebuild profitability and repair balance sheets.
- › The overall cost profile has not changed substantially this season. This is a function of higher pricing for some inputs being offset by more favourable seasonal conditions reducing costs in other areas.
- › Beyond the time horizon for this iteration of the indices, on current indications the 2018/19 season will likely see opening prices again form the main margin driver, with the cost outlook largely unchanged.

Figure 1 Export region weighted cost and income indices



Source: Dairy Industry Farm Monitor Project, Dairy Australia analysis



Inputs

Key
● Positive ■ Neutral ● Negative



Fertiliser

Urea (granular Middle East)

219 US\$/t

- +1% LY
- -19% 5Y

DAP (US Gulf)

385 US\$/t

- +22% LY
- -7% 5Y

MOP (granular Vancouver)

214 US\$/t

- +4% LY
- -22% 5Y

Price is December 2017 average, compared to the 2016 December average (LY) and 5 year (5Y) December average.

Source: World Bank

Water and weather

Northern Victoria

75 \$/ML

- -56% LY
- -32% 5Y

2,510,206 ML

- +74% LY
- +36% 5Y

Murray Irrigation System

72 \$/ML

- -54% LY
- -89% 5Y

251,348 ML

- +127% LY
- +37% 5Y

Price of water traded is 12 month average and volume of water is 12 month total, both to December 2017, and compare to year earlier (LY) and last 5 years (5Y).

Source: Victorian Water Register, Murray Irrigation Ltd.

Cows

Cull cows

442 c/kg

- -6% LY
- +17% 5Y

71,434 head

- -33% LY
- -7% 5Y

Dairy cattle exports

47,377 head

- -29% LY
- -35% 5Y

Price is December 2017 average, compared to December last year (LY) and 5 year (5Y) averages. Number of head is last 12 months (cull cows to December dairy cattle exports to December 2017) compared to year earlier (LY) and 5 year (5Y) averages.

Source: NLRs, ABS

The three month seasonal outlook predicts wetter weather in western parts of Australia and close to equal chance of above or below average rain for the rest of the country.

Weather

Despite the dry start with rainfall tracking around 33% below the national average in September, spring was overall wetter than average in most of Australia as a result of heavy rain during October and November, that continued into December.

In December, water temperatures in the Pacific reached the La Niña threshold and the Bureau of Meteorology (BOM) updated the ENSO outlook to La Niña. Typically a La Niña brings above average rainfall and increases the chance of warm weather in eastern Australia. The BOM suggests current La Niña is weaker than previous ENSO events and predicts it to be short-lived with little effect on Australian rainfall. The seasonal outlook for the remainder of summer and autumn predicts wetter weather in western parts of Australia and close to equal chance of above or below average rain for the rest of the country.

Temperatures tracked 'above' to 'very much above' average during spring and the start of summer with day and night time temperatures 'above' average. Despite warm temperatures some frosts were reported in spring which damaged crops. In December temperatures were amongst the highest ever recorded nationally for Australia. The BOM seasonal outlook suggests the rest of summer and start of autumn will be cooler than average for most states but warmer than average in Tasmania.

Water

Following an unusually dry winter water levels in all major dams increased in spring, thanks to the wet weather. By December, levels in the Dartmouth and

Glenmaggie dams reached 88% and 97% respectively. Despite the above, overall storage volumes are lower than last year by 18% in the Hume dam and 4% in Eildon. By the beginning of summer all major systems had reached 100% high-reliability water shares. The Northern Victorian Resource Manager (NVRM) suggests further resource improvements may occur given summer rainfall.

Notwithstanding this, the dry start to spring led to a boost in water trades in northern Victoria. Traded volumes increased 93% compared to last year, up to 574,000 megalitres. In December after a few months of above average rain, trading eased, down 27% to 161,000 megalitres compared to 2016, but elevated compared to the five year average, up 5%. During spring water prices in northern Victoria increased. The average price tracked 9% above last year at \$118/ML. In December prices started to fall, down to \$88/ML, a 12% drop compared to last year and 21% below the five year average. The largest drop in price occurred in Zone 1A (Greater Goulburn), down 23% compared to previous year.

Water trading in the Murray Irrigation system also increased during spring. In December trading eased slightly on a monthly basis but remain elevated compared to last year, up 56% to 12,200 megalitres. During this time prices increased and the December price \$106/ML is 43% higher than last year and 7% above the five year average.

Fertiliser

The fertiliser industry continues to face subdued demand as global crop prices remain low. Supply is strong and many producers have capacity to increase production. Global fertiliser stocks are large and prices are under pressure. If crop prices increase significantly during 2018 fertilising prices may rise but given current outlook, prices are expected to remain low.

Logistical constraints in supplying urea to importing countries, together with rising demand, caused temporary price increases through spring. Prices rose 11% before decreasing in summer. December price is 1% above last year but remains subdued, 19% below the five year average. New production capacities are expected to result in continued oversupply and prices are predicted to remain low in 2018.

The MOP market is oversupplied and several large producers, including China, Russia, the United States and Canada, are forecast to increase production. Prices are suppressed and have been for some time. During spring, prices increased for the first time all year and the December price is 4% above last year but 22% below the long run average.

Demand for phosphate fertilisers (like DAP) decreased and supply increased during spring resulting in lower prices. Despite the drop in demand, DAP increased in price during 2017, up 22% compared to December 2016. Compared to the five year average prices are down 7% and continued oversupply is expected to keep prices low for some time.

Cull cows

Cull cow prices reached a peak during winter 2017 before falling in spring; the October price of 420c/kg was the lowest reported for 15 months. In December prices recovered somewhat, to 442c/kg, a 6% drop compared to last year. During the second half of the year average price was down 11% compared to previous year but elevated 17% on the five year average.

During 2017, 71,000 dairy cows were culled, a 33% decrease from previous year and 7% below the five year average, as the national herd rebuilds. 2017 marks the first drop in annual dairy culling rates since 2014. Given current conditions the national herd is forecast to reach pre-drought levels by 2020. Culling rates increased in December, up 13% compared to last year following unfavourable weather in many regions. The average carcass weight reached record breaking levels and increased close to ten kilos year-on-year in 2017. According to the Meat and Livestock Industry Projection culling rates are forecast to increase slightly during 2018 while carcass weights are expected to drop.

Australian beef exports in 2017 are estimated to reach the same level as 2016 but several trade shifts have occurred. Japan continues to be the largest market for Australian beef and export volumes increased 11%. Exports into China also increased which helped offset decreases in other markets. Beef exports into the United States decreased as a result of increased domestic production and exports to Korea decreased for the first time in five years, down 17% as competition into the market increased. Competition on the global beef market is forecast to intensify during 2018 as the United States, India and Brazil expects to increase production. Beef production in the United States is predicted to reach record breaking levels as a result of a large corn crop, increasing domestic demand and renewed trade access to China.

Despite increased competition Australian exports are expected to grow during 2018 however price and export opportunity will depend on demand and per capita consumption increases to absorb additional beef available on the market. Meat and Livestock Australia predicts international prices to ease following increased competition.

Hay

During spring prospects for this season's hay harvest improved following unusually wet weather. Demand decreased as rain provided grazing opportunities and continued to top up pasture in paddocks. The hay market was mainly dormant during the last

months of 2017 as buyers and sellers waited for the completion of harvest to determine new season quality and price. In many regions growers tried to offload carryover hay to make room in sheds and prices remained subdued.

The wet weather raised quality concerns as rain interrupted the curing and baling of hay and reports suggest higher moisture content in bales than usual. Feed tests are crucial to ensure value for money when buying hay this season.

Northern Australia

Demand for hay in northern regions eased in spring as unusually wet weather increased grazing opportunities, as a result prices fell. Demand continued to be low during the start of summer and the market subdued. Wet weather deteriorated some growers' ability to make hay as curing got interrupted by rain.

Northern regions are expected to experience a feed-gap this season as the new harvest is too small to cover local demand. As demand is expected to exceed supply, prices are predicted to increase as hay is freighted from further south.

Cull cow prices reached a peak during winter 2017 before falling in spring; the October price of 420c/kg was the lowest in 15 months.

Southern Australia

The hay market in southern regions remains subdued with minimal demand, interest or trading taking place. Late spring rains further eased demand and topped up pastures in paddocks. Quality is highly variable as many growers tried to offload carryover stock to make room in sheds and care should be exercised when purchasing feed this season.

Southern Australia is predicted to produce more than enough hay this season and will be a strong source of supply for the rest of the country. 2017 proved to be a good silage year complementing the large supply of hay available. Following two years of strong supply hay demand is minimal and not expected to increase.

Western Australia

In Western Australia demand for hay was dormant during spring as the weather provided amenable conditions for the harvest. Reportedly new season harvest is of superior quality and higher yields than previously expected. Good supplies of carryover stocks exist within the region but care should be taken when purchasing this hay due to variation in quality.

The export industry continues to dominate the hay market in western regions and provides a solid pricing indicator.

Grain

World production of grain (wheat and coarse grains) in 2017/18 is predicted to reach 2.1 billion tonnes, a sharp upwards revision to previous forecasts. World production of grain is expected to decrease slightly on an annual basis, down 2%, but will still be the second largest crop ever recorded. Global grain trading is forecast to increase on a yearly basis, up 1%, and larger consumption of grain is projected to lead to the first contraction of grain stocks since 2012/13, down 0.8% to last year. This is a result of larger imports of grain into Africa and parts of Asia, led by increasing Indian imports. Demand for wheat increased in sub-Saharan African countries due to higher incomes and population growth, intensifying imports into this area. Despite the small contraction, global grain stocks are expected to be unusually large.

The revised grain production outlook originates from larger than anticipated increases in world production of wheat and maize during summer due to higher yields and an increase in planting acreage. In 2017 wheat production in Russia proved record breaking and relieved some of the market pressure following smaller wheat crops in many exporting countries. Wheat production in 2017/18 is expected to reach 757 million

tonnes according to the *International Grains Council*, a 0.2% increase compared to last year's record breaking crop and the largest on record. Global demand for wheat remains strong and with a decrease in wheat production expected in 2018/19, stockpiles might shrink for the first time in six years. During spring wet weather caused problems with the Australian wheat crop and negatively impacted the harvest and unharvested wheat leading to price increases. Towards the beginning of summer wheat prices eased slightly as the harvest finished up.

Production of coarse grains is predicted to reach 1.37 billion tonnes in 2017/18, a 1.8% increase compared to last year. Production of maize is expected to drop 34 million tonnes, down to 1.05 billion tonnes, compared to last season. This is a smaller than previously forecast drop as a result of upwards yield revisions in the United States and increased planting. Barley production is also expected to fall this season.

ABARES' December Crop Report suggests total winter crops in Australia will fall to 34.9 million tonnes in 2017/18 following unfavourable production conditions during spring in some regions and a decrease in overall planting. This is a 41% drop compared to last season's record breaking crop but only 2% below the 10 year average. Australian wheat production is expected to decrease 41% to 20.3 million tonnes, while barley is predicted to drop 40% to 8 million tonnes and canola 31% to 2.9 million tonnes. Summer crop production is expected to increase 13% this season according to the ABARES report.

For ongoing information and updates on farm inputs, readers can subscribe to Dairy Australia's monthly Production Inputs Monitor, or the weekly Hay and Grain Report, found on the Dairy Australia website at: dairyaustralia.com.au/industry/farm-input-and-costs

National grain and hay prices

Key

- Positive
- Neutral
- Negative

Australian dairy regions

Grain and hay



The relevant stockfeed wheat available in a region (ASW, AGP, SFW1 or FED1).

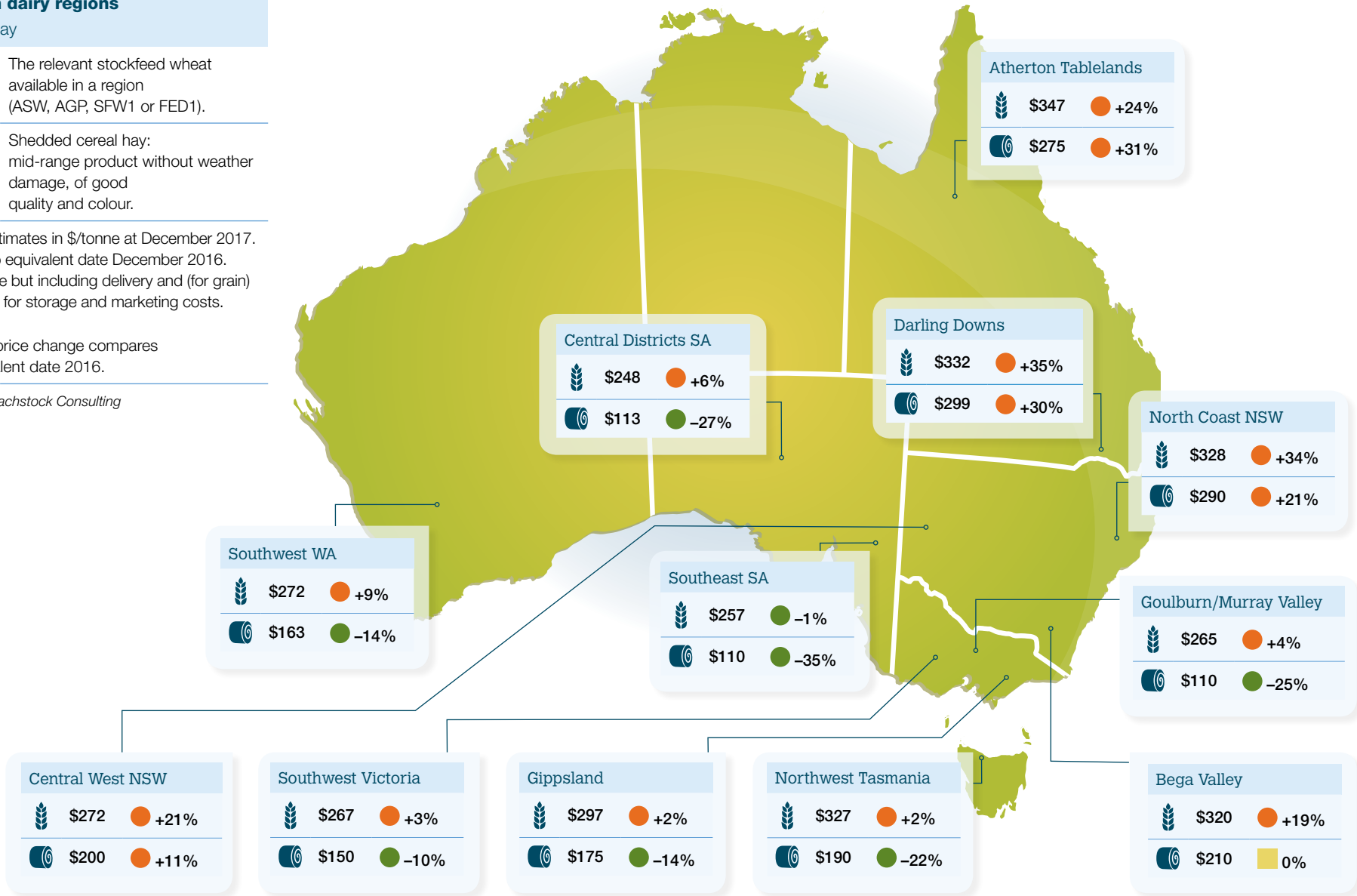


Shedded cereal hay: mid-range product without weather damage, of good quality and colour.

Prices are estimates in \$/tonne at December 2017. Compared to equivalent date December 2016. GST exclusive but including delivery and (for grain) an allowance for storage and marketing costs.

Percentage price change compares to the equivalent date 2016.

Source: AFIA, Lachstock Consulting



The Australian market

Key
● Positive ■ Neutral ● Negative

Milk

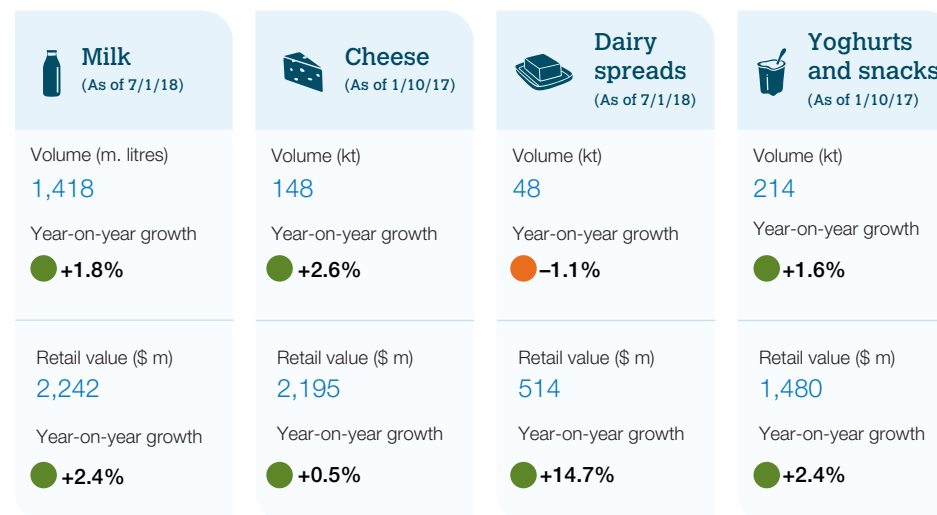
Total drinking milk sales volumes grew by 1.8% to 1,418 million litres over the 12 months to January 2018, whilst the value of supermarket drinking milk sales grew 2.4% to over \$2,242 million. Fresh white milk showed moderate growth, with sales volumes increasing by 1.6% to 1.2 billion litres. Within the fresh white segment, full cream fresh milk continues to grow strongly, with sales volumes increasing 5.9%. Consumers continue to move away from skim and low-fat milk varieties in favour of full-fat milk varieties.

Private label fresh milk has continued to regain market share now accounting for 649 million litres, or 59% of fresh white milk sold in supermarkets. Prior to the massive consumer response to the segment 'Milked Dry' aired on The Project in 2016, private labels' market share was around 66%. Average prices for fresh white milk have remained largely unchanged, with the average national price flat at \$1.38/litre, with branded milk retailing at \$1.89/litre and private label retailing at \$1.03/litre. Given this difference in average prices, company branded milk retains a greater share of the market when measured by sales value, with supermarket sales of company branded fresh white milk accounting for approximately \$850 million.

Flavoured milk sales have continued to grow over the last 12 months, with total volumes of fresh flavoured milk growing 7.1% to 133 million litres, whilst sales value grew by 6.7% to \$473 million. As a segment of the drinking milk market fresh flavoured milk now represents over 20% of the total drinking milk category by value, despite accounting for less than 10% of it by volume. Given the importance of brand profile, and the sustained growth in the segment, it seems likely that flavoured drinking milk will become increasingly important for dairy beverage companies in the future.

Overall sales volumes of UHT product were fairly flat over the 12 months to January 2018, down less than 1% to around 187 million litres. Company branded white UHT milk accounted for most of this decline, falling by 3.9%, whilst private label white UHT increased at the same rate. Sales of UHT lactose free milk grew by 9.5% to 21 million litres, with branded UHT lactose free milk volumes up by 10.3%, to 17 million litres, selling at an average price of \$2.09/litre. Total sales volumes of lactose free milk (UHT and fresh) increased by 12.8% to 44.7 million litres, worth \$101 million.

Figure 2 Australian supermarket sales (As of 7/1/18)



Source: Aztec-IRI

Note: Available data is taken from differing periods; milk and dairy spreads from MAT 7/1/18; cheese and yoghurt and snacks from MAT 2/10/2017.

Cheese

Total supermarket sales volumes of cheese have grown 2.6%, whilst the total value of supermarket cheese sales has increased only 0.5%. Within the cheese category, sales of deli-section cheese increased 6.0% in terms of volume, to 23,770 tonnes. The value of deli-section cheese grew 5.6% to \$594 million, with the average price of deli cheese more-or-less flat at \$25.01/kg. The relative strength in sales of deli cheese helped to offset weaker performance in the chilled cheese category.

Within the chilled cheese segment, sales volumes grew 1.9% reaching 124,590 tonnes, whilst sales values fell by 1.2% to \$1.6 billion. As with many other food categories, cheese prices continue to experience persistent downward pressure, with supermarket chilled cheese prices declining by 3.1%, from \$13.26/kg to \$12.85/kg.

Sales of ingredient and cooking cheese types have continued to grow strongly, up 7.2%, however the value of this segment fell 2.6%. The growth in sales of ingredient and cooking cheese is also reflected in the changing pack sizes consumers are buying, with sales volumes of 650g-1kg pack sizes up 48% on a year ago, and now accounting for 16% of the chilled cheese supermarket by volume, compared to 11% in the previous sales period.

Meanwhile, the sales volumes of block cheese (previously the most popular kind of chilled cheese sold) have continued to fall, down 6% to 38,300 tonnes, while sales of higher margin products, such as sliced and snacking cheeses grew 5.1% and 14.7% respectively.

Yoghurts

The yoghurts and dairy desserts category has shown a slight growth in sales volumes, up 1.6% in the 12 months to October 2017. The value of the category grew, up 2.4% to \$1,480 million. Within the category, dairy yoghurt volumes grew by 1.9% from 165,000 to 169,000 tonnes.

Within the dairy yoghurt category, the trend of consumers adopting traditional, unsweetened varieties of yoghurt in preference to sweetened yoghurt continues, with traditional dairy yoghurt sales growing 7% to 84,000 tonnes, whilst sweetened yoghurt sales volumes fell by 3.3% over the 12 months to October 2017. In value terms traditional yoghurts sales increased 5%, or less than volume growth. This was due to a 1.9% fall in the average price of the traditional segment, from \$7.26/kg to \$7.12/kg. Average prices for sweetened yoghurt also declined, but by less, from \$5.44/kg to \$5.61/kg. The ongoing transition from sweetened to traditional yoghurt is also supported by data showing the continued growth in sales of bulk packs, at the expense of multipacks more commonly favoured for sweetened yoghurts.

Spreads

Total supermarket sales value of dairy spreads grew by 14.7% in the 12 months to January 2018, to \$514 million. This dramatic growth in the sales value of dairy spreads can be attributed to stronger global demand for dairy fats and higher world prices. Average butter prices increased 25% over the last 12 months, from \$8.44/kg to \$10.57/kg. These higher prices seem to have affected consumer demand for butter, with total sales volumes of butter down 3.2% to 25,600 tonnes. Sales volumes of blends (containing both butter and cheaper vegetable oils) actually increased by 1.3% to 22,860 tonnes, suggesting substitution by the most price sensitive consumers. Interestingly, the steepest price increases and drop-off in consumer demand has occurred in private label butter, with average

prices increasing from \$5.62/kg to \$8.36/kg or 48.7% - resulting in a 5.5% decline in sales volumes. In contrast, company branded butter prices increased by 12.6%, from \$11.25/kg to \$12.66/kg, however sales volumes fell by less than 1%. This suggests a marked shift in consumer attitudes towards butter and dairy fats, changing consumer preferences and making butter demand relatively unresponsive to price changes. Secondly, there seems to be considerable consumer loyalty and willingness to pay for branded butter products, despite significant price differences, at a time when private label products have increased their market share in other dairy categories such as cheese and drinking milk.

Figure 3 Supermarket chilled cheese sales

Packsize	Share of market	Price	Price growth	Volume '000 (t)	Volume growth
100-199g	5.8%	\$29.60	-0.8%	7.2	3.1%
200-299g	20.6%	\$17.78	-1.3%	25.7	-1.8%
400-649g	39.4%	\$11.57	-1.2%	49.1	-9.1%
650-999g	16.3%	\$8.56	-13.7%	20.3	27.9%
1.0-1.49kg	17.1%	\$7.69	-2.8%	21.3	-4.1%



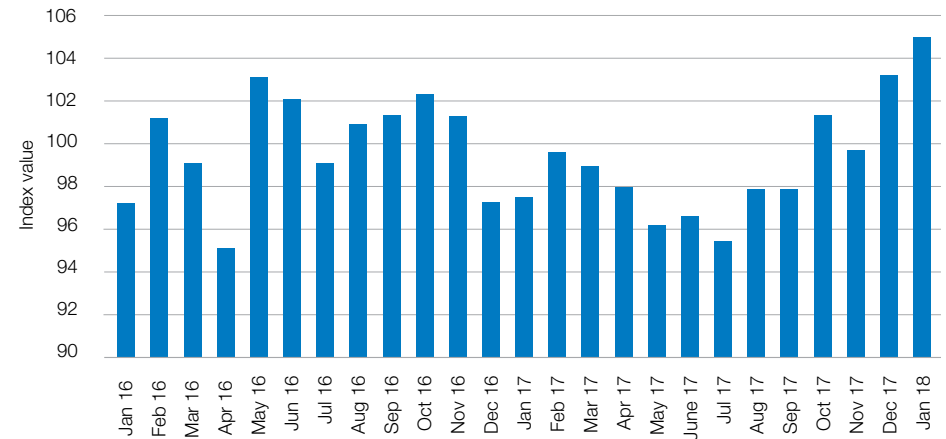
Economic settings

The Westpac-Melbourne Institute Consumer Sentiment Index for January 2018 increased by 1.8% to 105.1 points, up from 103.3 in December 2017. This marks a considerable improvement in consumer outlook since the last Situation and Outlook Report, when the September 2017 Consumer Confidence was 97.9. Notably, this is the highest level of consumer confidence since late 2013, and also marks the third consecutive month above 100 (indicating that optimists outnumber pessimists) after almost a year languishing below this barrier. Broadly speaking, it suggests that consumers and households are feeling cautiously more optimistic about their future income and finances. This may affect their decision making, leading them to increase consumption of discretionary items (such as eating out), or more premium products, such as butter instead of margarine.

Dairy Australia's Food Service Index continues to show increased consumer spending on food and food services across all the major channels, with increases reported revenue in the supermarkets, takeaway, cafe, restaurant and catering businesses. However, the growth in food service and takeaway and QSR has slowed somewhat, particularly in Western Australia. Supermarket sales remain robust.

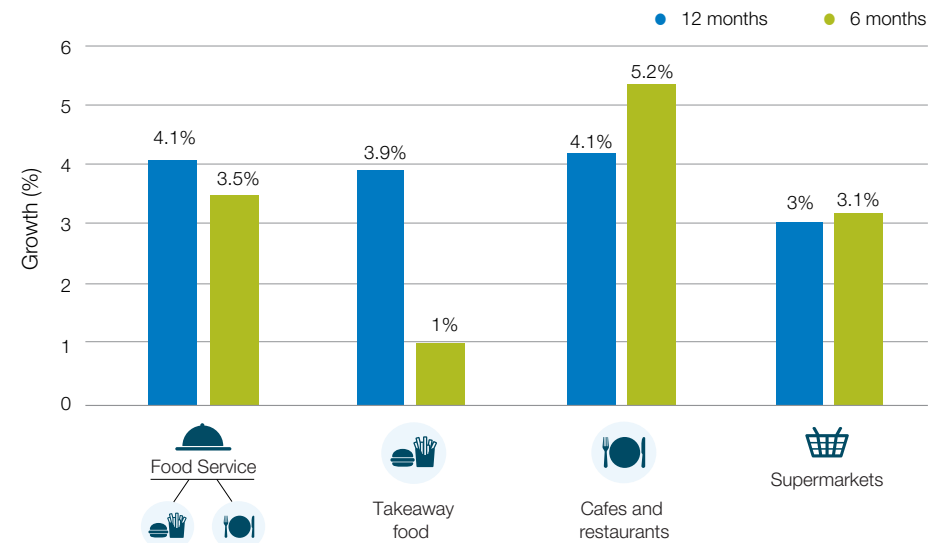
The most recent data on inflation from the ABS December Quarter CPI has come in below expectations, with the headline CPI rising 0.6% for the quarter, below the 0.7% expected, for an annualised headline inflation rate of 1.9%. Within the CPI, food and non-alcoholic beverages continue to show signs of deflation, with the index down 0.2% on an annualised basis. As a food group, average dairy price levels were down 0.3% on an annualised basis. Similar to the Food Service Index, there were noted differences in price levels between states, with the eastern states showing inflation rates above 2.0%, however weakness in Western Australia brought the national average down. This persistently low inflation can be attributed to a number of factors, including weak wage growth, sustained competitive pressure in retail and slower rental growth, particularly in WA. The continued weakness in inflation, which has remained below the RBA's target band of 2%–3%, suggests that any increase in official interest rates will be unlikely in the near term.

Figure 4 Australian consumer confidence



Source: www.tradingeconomics.com, Westpac Banking Corporation, Melbourne Institute

Figure 5 DA Food Service Index (YoY turnover growth to November 2017)



Source: Dairy Australia, ABS

Global economy and exchange rates

In the latest World Economic Outlook report (January) the International Monetary Fund (IMF) suggests global economic output grew 3.7% in 2017, a 0.1% upward revision compared to previous forecast. This revision is a result of increasing growth expectations in Europe, Asia and the United States and strong commodity prices leading to higher than anticipated inflation rates in developed and developing countries. Economic growth is predicted to reach 3.9% in 2018 as a result of an increasingly optimistic market outlook. Changes to US tax policy are projected to stimulate demand and trade, resulting in further growth.

Increasing growth rates are contributing to global economic recovery and according to the IMF the world economy has been in a cyclical upswing since 2016. Growth rates in developing countries are increasing more rapidly than in developed countries and represent 50% of total growth. As a result world trade grew in 2017. The IMF suggests risks to global growth are relatively low in the near future but that slower than anticipated investment rates into the US following the new tax policy, combined with trade barriers and protectionist policies, pose a threat to global economic output.

After reaching its peak in October, the Australian dollar depreciated slightly against the USD during spring before firming during summer, up to 0.79 AUD/USD in January 2018. During the same period the NZD depreciated against the USD before appreciating in January, reaching 0.72 NZD/USD. The euro continues to strengthen against the USD, up to 0.82 USD/EUR, the highest rate since 2015. The weak USD improves cost-competitiveness for exports from the US, however the effect on the Australian dairy industry is still not expected to be too pronounced given the currency appreciation in other dairy exporting countries. The median consensus forecasts the AUD to depreciate against the USD during 2018, down to 0.74 AUD/USD, however some major banks are suggesting the AUD might continue to appreciate. The NZD is expected to depreciate against the USD, down to 0.70 NZD/USD, while the euro is predicted to appreciate against the USD, reaching USD/EUR 0.79 towards the end of 2018.



Global supply and demand overview

Export demand remains steady, with export volumes up 2% in the last year - driven largely by China and Japan.

United States

US exports have begun to recover as growth in the domestic market lags that of milk production.

Export volume trends

Total volume change:
 ▲ 6% to 2,142,236 tonnes

Significant product shifts

- ▲ Cheese (20%)
- ▲ Whey powder (14%)
- ▲ SMP/NDM (7%)
- ▼ Lactose (-1%)

European Union

Cheese is the product of choice for EU manufacturers at the moment, with exporters also keen to shift SMP.

Export volume trends

Total volume change:
 ▲ 9% to 4,832,154 tonnes

Significant product shifts

- ▲ SMP (28%)
- ▲ Cheese (3%)
- ▼ Liquid milk (-6%)
- ▼ WMP (-11%)

Russia

Russian import volumes have grown strongly from the low levels of 2015/16, with the EU, NZ and South America all increasing their exports.

Import volume trends

Total volume change:
 ▲ 33.9% to 141,543 tonnes

Significant market shifts

- ▲ North America (46%)
- ▲ South America (15%)
- ▲ European Union (20.5%)
- ▲ New Zealand (236.4%)

Southeast Asia

Steady growth in volumes, with a notable recovery in SMP tonnage. EU and US have gained share in the region.

Import volume trends

Total volume change:
 ▼ -0.6% to 2,450,874 tonnes

Significant market shifts

- ▲ North America (0.2%)
- ▼ South America (-13.7%)
- ▼ Australia (-0.7%)
- ▲ European Union (7.4%)
- ▼ New Zealand (-7.2%)

Middle East/North Africa

Dairy import volumes fell for a second consecutive year. Shipments to Saudi Arabia and Egypt are down the most, offsetting increases in other countries.

Import volume trends

Total volume change:
 ▼ -6.7% to 2,576,522 tonnes

Significant market shifts

- ▲ North America (3%)
- ▼ South America (-54%)
- ▼ Australia (-46.3%)
- ▲ European Union (3.3%)
- ▼ New Zealand (-16.9%)

Mexico

Slower growth than preceding two years, but so far uncertainty about NAFTA yet to be reflected by any major changes in trade patterns.

Import volume trends

Total volume change:
 ▲ 1% to 705,514 tonnes

Significant market shifts

- ▲ North America (0.3%)
- ▼ South America (-56.3%)
- ▼ Australia (-39.5%)
- ▲ Europe (58.3%)
- ▼ New Zealand (-19.7%)

Greater China

Restrained growth in imports compared to previous years, but changing product mix and higher prices driving value growth.

Import volume trends

Total volume change:
 ▲ 11.7% to 2,615,814 tonnes

Significant market shifts

- ▲ North America (35.7%)
- ▼ South America (-46%)
- ▲ Australia (12.4%)
- ▼ European Union (-8%)

Japan

A recovery in Japanese import volumes, led by SMP and whey powder, with a corresponding increase in import values.

Import volume trends

Total volume change:
 ▲ 15.1% to 468,695 tonnes

Significant market shifts

- ▲ North America (13.1%)
- ▼ South America (-40.2%)
- ▼ Australia (-0.5%)
- ▲ European Union (42.5%)
- ▲ New Zealand (7.5%)

Australia

Growth in liquid milk exports has slowed in the face of stiff competition, whilst WMP has seen a lift after successive declines.

Export volume trends

Total volume change:
 ▼ -2% to 814,541 tonnes

Significant product shifts

- ▲ Liquid milk (6%)
- ▲ Cheese (3%)
- ▼ SMP (-3%)
- ▼ WMP (-13%)

New Zealand

Whilst maintaining WMP volumes, NZ continues to push milk into other product streams.

Export volume trends

Total volume change:
 ▼ -3% to 3,190,173 tonnes

Significant product shifts

- ▼ Cheese (-1%)
- ▼ WMP (-1%)
- ▼ Liquid milk (-11%)
- ▼ SMP (-13%)

Changes 12 months to October
 Source: GTIS, Dairy Australia
 Note: Includes mixtures

 Four largest exporters

Global demand

Overview

The volume of dairy products exported by the six major exporters (the EU, US, New Zealand, Australia, Argentina and Uruguay) increased by 2% over the 12 months to October 2017, while the value of global exports was up 13.7% on the same period 12 months ago, with strong growth in the value of cheese, SMP and WMP exported.

The volume of Australian dairy exports to the rest of the world over this period fell by 2.4%, totalling 720,000 tonnes, with butter and WMP categories weighing most heavily on Australian export volumes. Australian butter exports fell to only 12,400 tonnes,

the lowest volume recorded since at least 1990. WMP exports fell from 63,800 tonnes to 55,200 tonnes, a decline of 13.4%.

In spite of lower export volumes, the value of Australian exports grew by 7.1% to US\$2,052 million. The value of Australia's SMP exports rose by 11.5% to US\$377 million compared to US\$338 million in 2015/16 and US\$560 million in 2014/15. Australian cheese exports declined slightly by volume however they increased in value, with the majority of Australian cheese exports going to Japan. The decline in export volumes and value in other product categories was largely offset by extraordinarily

strong growth in infant formula, export volumes of which increased by 25%. The value of Australian infant formula exports in 2016/17 totalled US\$334 million, compared to US\$296 million in 2015/16 and US\$85 million in 2014/15.

Greater China

Exports to Greater China (PRC, Macau and Hong Kong) from major exporters grew by 11.7% in volume over 2016/17, while the value of world dairy exports to China grew by 25.4% to US\$7,970 million, with the value of WMP (+42%) and infant formula (+16%) exports up, to US\$1,622 million and US\$2,543 million respectively. Increased exports of whey powder, cream and SMP have also contributed to the strong growth of the Chinese market. This is consistent with industry commentary pointing to lower domestic production in China and the continued cost competitiveness of imported product, particularly from Australia and New Zealand. Imports of liquid milk from major exporters have fallen considerably over the same period, easing 12% from 620,000 tonnes to around 546,000 tonnes, with much of this decrease appearing to have come from the European Union, and Germany in particular.

Australian export volumes grew by 12.4%, from around 179,000 tonnes to almost 202,000 tonnes, while the value of Australian exports increased

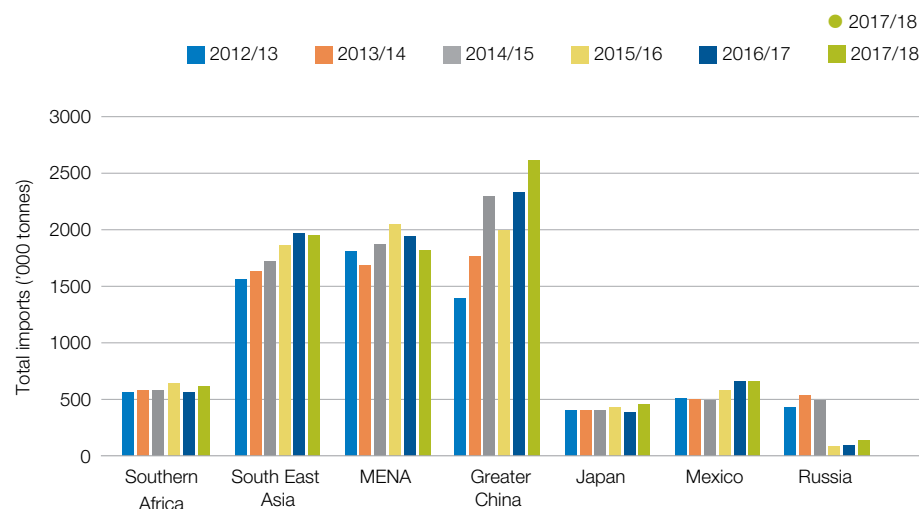
by 17.7% year-on-year, from US\$594 million to almost US\$700 million in the 12 months to Q1 2017/18. The largest single increase came from the value of Australian exports of infant formula, which grew from US\$267 million to US\$308 million, while SMP, WMP and cheese largely accounted for the remaining increase in Australian exports.

Japan

Direct dairy exports from major dairy producers (not including re-exports via Southeast Asia) to Japan grew by 15.1%, from 407,000 tonnes to 467,000 tonnes. The largest single increase occurred in lactose, growing 31.1% to 93,000 tonnes, with SMP and cheese also seeing significant increases. The value of dairy exports to Japan increased by 25%, from US\$1,212 million to US\$1,515 million. Over the course of 2017/18 the European Union has increased its share of the Japanese market amongst major exporters, from around 25.3% of Japanese imports to over 31.3%, by volume. The increased presence of EU exports is particularly noticeable in the cheese category, where it has successfully increased its market share to around 27%, whilst Australia's share of cheese exports to Japan has retreated to around 33%.

Over 12 months to Q1 2017/18 the volume of Australian exports to Japan eased slightly, down 0.5%, to 95,000

Figure 6 Exports to key demand markets (twelve months to October 2017)



Source: Dairy Australia, GTIS

tonnes, while the value of Australian exports grew by 8%, reflecting higher world prices. The largest volume decline was in the cheese category which fell by 4% to 81,000 tonnes. Over the same period, the value of Australian cheese exports increased by 6.7% to US\$292 million. Australian SMP and whey powder export volumes grew strongly, partially offsetting the decline in cheese volumes.

Southeast Asia

Dairy trade volumes to southeast Asia have remained largely flat with the US, EU, Argentina, Uruguay, Australia and New Zealand exporting around 1,961,000 tonnes over the 12 months to the end of Q1 2017/18. The largest changes were in powders, with volumes of SMP exported to the region up 7.2% to 658,000 tonnes, with Malaysia (+13.6%) and the Philippines (+13.8%) accounting for the largest increases. This increase in SMP volumes was offset by smaller declines in whey powder and WMP, down 8.4% and 3.7% respectively.

The total value of exports to the region increased by 21.1% to US\$4,415, with SMP exports up by 18.6% to US\$1,390 million, making it the single most valuable export category in the region. The value of whey powder and WMP were up by 15% and 30% respectively despite the lower export volumes, reflecting the improvement in global dairy prices compared to the previous 12 month period.

Exports to Malaysia grew by 4%, with increases in SMP, cheese and lactose

serving to offset declines in imports of whey powder. Dairy exports to Singapore fell by 4.9% to 262,000 tonnes, with falls in exports of whey powder accounting for the largest declines. The Philippines continues to be a robustly growing market, with export volumes increasing by 6.8%, from 393,000 to 420,000 tonnes, lifted by growth in exports of whey powder and SMP. Exports to Indonesia from major dairy exporters were largely flat, with major export categories such as whey powder, SMP, WMP and lactose moving only slightly.

EU SMP exports to the region have increased significantly over the 12 months to October 2017, from 148,000 tonnes to 215,000 tonnes, an increase of 45%. The EU has also increased its export volumes of lactose (from 21,000 to 28,000 tonnes), which has come at the expense of US lactose exports. US dairy export volumes to the region have otherwise been largely flat, whilst New Zealand's exports to southeast Asia have fallen by 7.2% over the same period, to around 640,000 tonnes.

Australian export volumes to southeast Asia have eased slightly, down 1% over the period, with increased volumes of liquid milk (+7.9% to 81,000 tonnes) unable to offset declines in whey powder and smaller decreases in SMP and butter fat volumes. Australian export volumes grew most strongly in Malaysia with export volumes up 6% and values up 8%. Singapore remains Australia's largest export market in southeast Asia, however Australian export volumes to Singapore have fallen by 8% to around 77,000 tonnes, worth

US\$141 million. Australia has increased its exports to Indonesia and Malaysia quite successfully over the same period, with export volumes to both markets now around 55,000 tonnes each, worth US\$131 million and US\$124 million, respectively. The total value of Australian exports to southeast Asia grew by 11% to US\$567 million.

Mexico

Dairy exports to Mexico over the 12 months to October 2017 were largely flat, up just 1% to 680,000 tonnes, with continued growth in US exports of SMP/NFDM and cheese and lower export volumes of liquid milk and AMF. Despite continued uncertainty over the future of NAFTA, US exports continue to make up over 80% of Mexico's dairy imports. The EU and New Zealand are competing for second place in market share, with exports from both up significantly over the last five years. Whilst Australia's current trade with Mexico is negligible, the apparent success of the modified Trans-Pacific Partnership may yet see growth in Australian dairy exports to this market, which since the trade embargoes on Russia has become the second largest single country dairy export market in the world after China, worth US\$1,772 million over the 12 months to October 2017.

Middle East and North Africa

Dairy trade with the Middle East and North Africa (MENA) region from the major exporters remains depressed, with total export volumes down 6.7% to 1,827,000 tonnes and big falls in exports of butter (-36%) and WMP (-19%). The decline in volumes appears to be mostly confined to New Zealand, where volumes have fallen from 630,000 tonnes to around 524,000 tonnes. The total value of exports has grown 3.6%, pulled up by higher global dairy prices, compared to the previous 12 month period.

Export volumes to Algeria were up 6.4% to 381,000 tonnes, reflecting large increases in SMP buying by Algeria's state procurement agency ONIL. Export volumes to Egypt remain heavily down (-40%), while total exports to Saudi Arabia were down around 18% to 285,000 tonnes. The United Arab Emirates saw modest growth, with increased imports of SMP and condensed milk.

Australia's dairy export volumes to the Middle East and North Africa continue to fall, down 46% to 25,000 tonnes. Australian exports to the region have come under tremendous pressure both from the EU and New Zealand, which has meant that the region now accounts for around 3% of Australian exports, compared to 12% six years ago. The value of Australian exports fell 34%, down to US\$76 million.

Russia

Dairy exports to Russia from major dairy exporters have grown strongly (+34%), however the total trade volume of around 142,000 tonnes remains at about less than a third of the pre-trade embargo level. These Russian trade embargoes remain in place for dairy imports from the United States, the European Union, Australia, Canada and Norway, although the EU still remains the largest exporter to Russia. New Zealand was not subject to the trade embargoes, and while its exports to Russia did decline immediately after the imposition of trade sanctions on Russia, New Zealand's dairy trade with Russia in the latest 12 month period now exceeds its pre-embargo volumes considerably. South American exporters, such as Uruguay and Argentina, have also been beneficiaries of the trade embargoes, at the expense of the EU.

Dairy affordability and substitutes

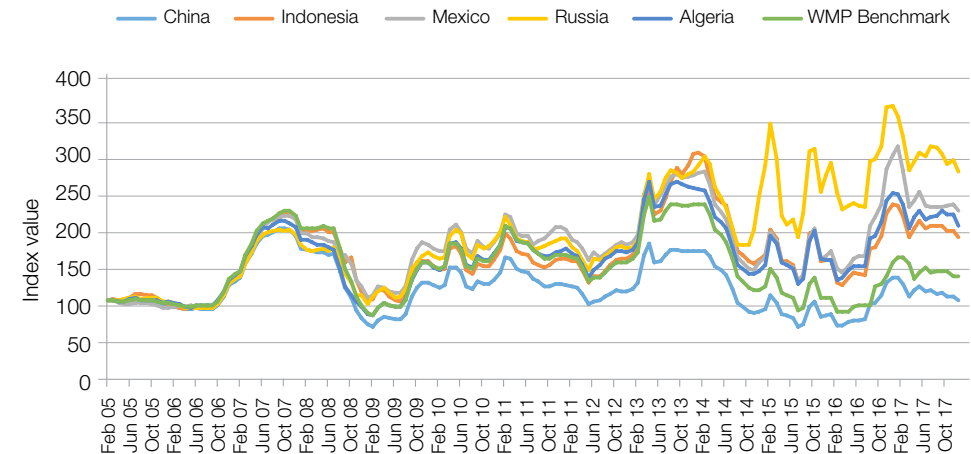
Dairy Australia's Import Affordability Index tracks changes in affordability for local consumers in key dairy import markets, seeking to account for both global dairy commodities' prices as well as local currency effect, with an appreciation of the local currency making US denominated dairy imports relatively cheaper. An increase in the index reflects worsening affordability for importing countries and indicates a potential slowdown in import volumes, particularly in the most price sensitive markets.

Previously, the Index had been based primarily on Skimmed Milk Powder prices, which is a major import category for many countries as well as a major Australian dairy export. However, since the creation of the Import Affordability Index, structural changes in dairy markets, such as the divergence between fat and protein prices, increased demand for dairy fats and the severe market distortions affecting SMP due to the European Union's stockpiles, have meant that global SMP prices are not necessarily representative of actual demand and affordability for dairy imports. For this reason, Dairy Australia has changed the Index to use WMP prices as the benchmark for dairy affordability.

Global Affordability

Import affordability has improved across the major observed markets over the last 12 months and has continued to improve since then. Most of this improvement is due to lower WMP prices (WMP Benchmark Index has eased 12% over the last year). Many of the major importers, notably China, Mexico, Russia and Algeria have also experienced an appreciation of their currency against the US dollar over the last 12 months. Broadly speaking, prevailing global conditions are supportive of continued growth in dairy imports.

Figure 7 Dairy affordability



Dairy price premiums and substitutes

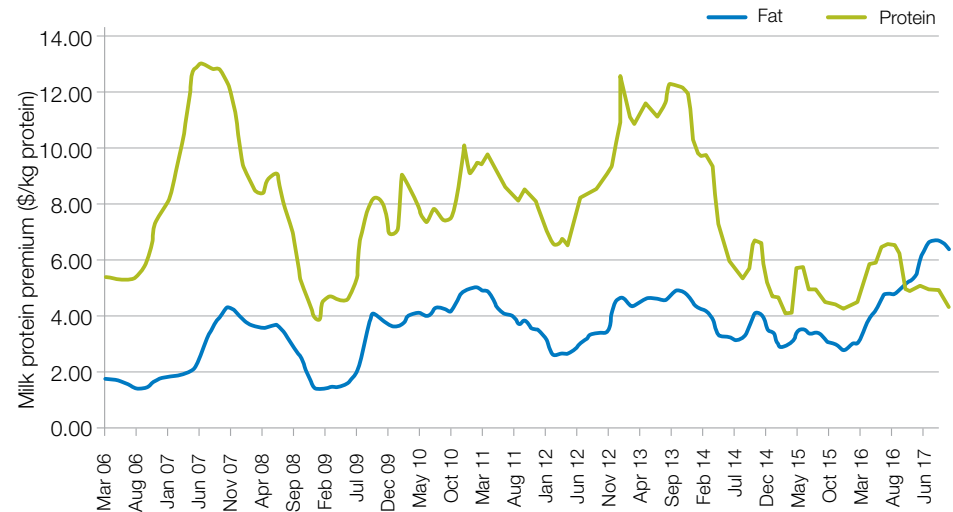
The divergent trends higher dairy fat and lower dairy protein premiums seen since the beginning of 2017 have continued. The butterfat premium is measured as the difference in US\$/kg prices between palm oil substitutes and dairy butter fats. Many food and ingredient manufacturers will typically alter the relative proportions of dairy fats and cheaper vegetable oils and shortening, substituting between dairy fats as relative prices and associated dairy premiums change.

The butterfat price premium for December 2017 was \$6.48/kg, well above the historical average of \$3.47/kg. Following a prolonged period of elevated dairy fat premiums, there appears to have been a slight easing of dairy fat premiums from a high of \$6.75/kg in July. It appears that consumers in many markets (including Australia) have responded to higher butter prices by reducing their consumption. Food processors and manufacturers also appear to be reducing their dairy fat content, whilst reports of dairy companies developing fat-filled products (SMP with vegetable fats added) also point to price-led substitution amongst dairy ingredients purchasers. Whilst international prices for dairy fats are expected to ease further over the short term, premiums will likely remain elevated above the long term historical average.

In contrast to fat, dairy protein price premiums remain at historically low levels, due largely to the significant SMP stockpiles in the European Union. Ongoing uncertainty about the EU Commission's plans for ongoing market intervention and intentions regarding the existing stockpiles have prevented any real recovery in SMP prices, and effectively placed a ceiling on SMP prices. With SMP prices so low and more milk expected from the northern hemisphere, there is currently little pressure for substitution towards non-dairy protein sources. Indeed, with SMP at historically low prices and almost an unwanted by-product of fat production, it is likely that manufacturers will seek new applications and uses for SMP, such as fat-filled milk powders.



Figure 8 Dairy price premium vs palm/soy substitutes

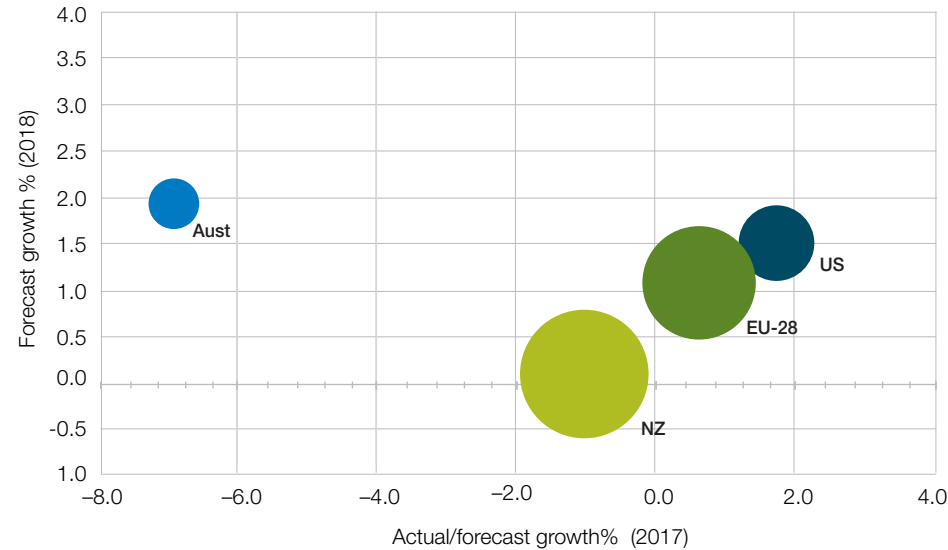


Source: Oilworld, Dairy Australia

Overview

Milk production in Europe has surged, putting renewed pressure on dairy commodity prices. Conversely, intakes in New Zealand have tracked below expectations so far, whilst the US shows a gently slowing rate of growth and Australia's year on year output fluctuates.

Figure 9 Actual and forecast milk production growth – four largest exporters

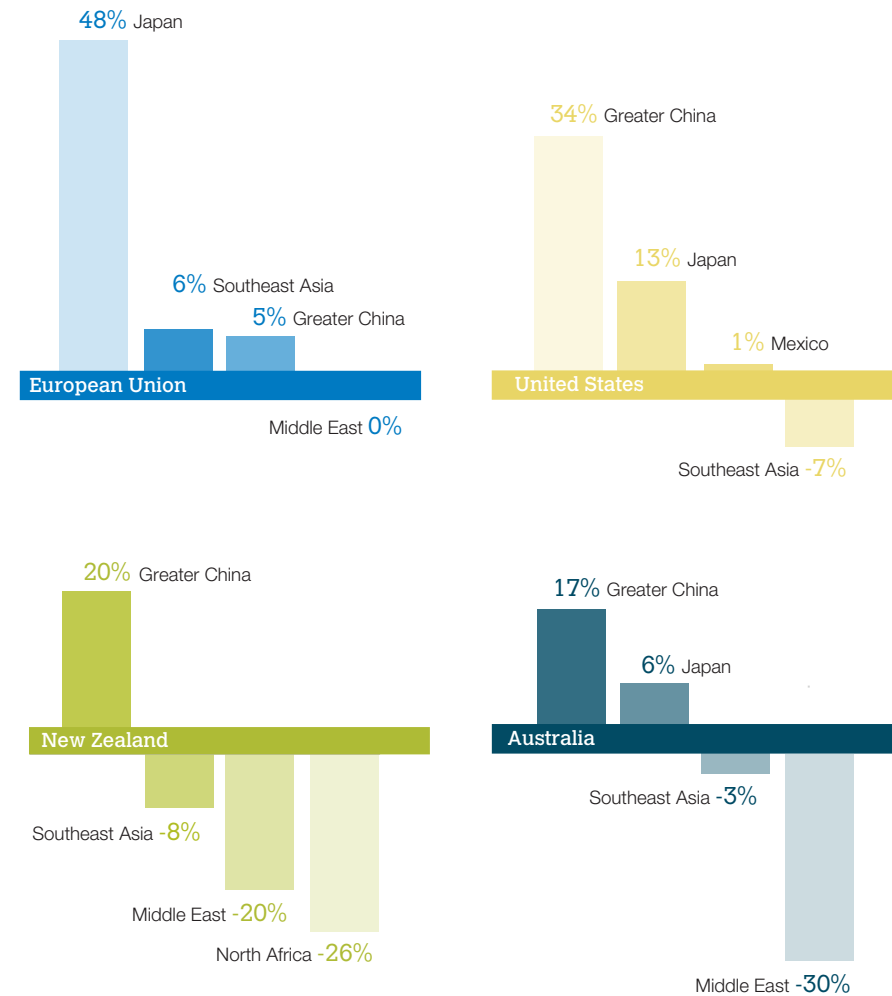


Note: Size of bubble represents share of global dairy exports.
Data covers production seasons for Aust and NZ, calendar years for US and EU.
Source: USDA, DCANZ, Eurostat, Dairy Australia

Figure 10 Farmgate price movements – four largest exporters

Change in indicative farmgate price	NZ	EU-28	US	Australia
Compared to last report (Oct 2017)	∨ -5%	∧ 21%	∨ -1%	∧ 5%
Compared to prior year (Feb 2017)	∧ 7%	∧ 34%	∨ -2%	∧ 9%

Figure 11 Key market volume changes, for top four exporters, year on year



Changes 12 months to October
Source: GTIS, Dairy Australia
Note: Includes mixtures

European Union

Growth in European milk production has been one of the key drivers in the deterioration of market sentiment since the northern hemisphere autumn. Year-on-year growth for the latest reported month (November) is at 6%, with the year-to-date total closing in on 2% for 2017. Only two members of the 28 nation European Union (Malta and Hungary) saw milk production decline in November, with significant growth coming from the major producers Germany (+6%), France (+5%), the UK (+8%) and Italy (+9%). These four nations added 407 million litres to last year's figure, in November alone. Even the Netherlands saw growth of 2%, despite its much-discussed culling program. Irish milk production is going from strength to strength – up 16% in November and 9% for the year to date.

Higher farmgate prices and the availability of cheaper, good quality feed (particularly maize silage) have boosted margins and spurred much of the increase in milk production. Increased feeding rates and more productive cows, after a high level of replacement in 2016, have also been important. According to the European Commission, cow numbers actually dropped for the first half of the year, with per-cow productivity more than offsetting this.

As in other parts of the world, depressed SMP prices have outweighed record butter values to pull down returns for the overall SMP/butter stream. Cheese production has represented a better proposition for those manufacturers with the ability to choose and consequently, the bulk of the additional milk has been directed this way. Robust demand from both European and international buyers helped support cheese prices for much of 2017, although the last months of the year did see some easing.

A strong recovery in exports (up 38% for the year to October), together with lower production has reportedly drawn down on commercial stocks of SMP, however sales out of intervention have remained stubbornly slow. In calendar 2017, 30,649 tonnes was purchased into storage, whilst a total of 180 tonnes was sold. The pace of sales has increased recently, with tenders for 1,864 tonnes recently accepted. At €1,190/tonne, compared to the, €1698/tonne purchase price, the Commission is making a tidy loss. In an attempt to control the volume of product entering storage in this year's program (opening March 1), the European Commission proposed, and the Council has decided, to forego the automatic buying-in of SMP at the fixed price. This is achieved by setting the quantitative limit at zero (rather than 109,000 tonnes) for 2018.

However, the EU will continue to be able to buy-in SMP through a tendering procedure, and to decide on a case by case basis how much to buy and at what price level. Hence the Commission retains the mechanism to support the market, but the price floor will not be guaranteed.

Whilst farmgate prices are now beginning to ease again, the European Commission still expects production to increase 1.2% in 2018.

United States

US milk production continues to grow, up 1% in December, ending 2017 with an increase of 1.4% for the year (for a total of 97.7 billion litres). The rate of growth peaked at 2.1% in August and has since slowed; a similar trend to the size of the national herd which increased by 0.5% in December (more slowly than 0.8% in July). Unlike Europe, the herd continues to grow, but both exporters are seeing per cow production growth outweighing that attributable to cow numbers.

There is some debate amongst US sources concerning the trend for the national dairy herd in 2018. Whilst the USDA forecasts a continued increase, other analysts are not so sure. The dairy and food market analyst group cite anecdotal evidence of increased culling and constrained capital expenditure

in suggesting that cow numbers have already peaked and are likely to decline. The herd reached 9.404 million cows in August, and has indeed fallen since (despite the positive year on year growth), sitting at 9.401 million in December. The USDA sees the herd rebounding to a peak of 9.42 million head later in 2018, and milk production growing 1.5% compared to 2017 – to 97.7 billion litres.

With the general US economy continuing to perform well, settings for the drivers of US domestic dairy consumption remain favourable, although demand has dropped in recent weeks. Conversely, despite weakening international prices, exports are increasingly back in favour. Commentary from local analysts suggests farmgate prices are likely to ease for the first half of 2018, before an eventual recovery. The impact for US farmers will be muted somewhat, however, if feed prices remain relatively low – as is widely expected. Increases in other costs, particularly labour and road haulage (with the mandated introduction of new electronic logging devices in trucks), are creating challenges outside the margin over feed cost calculation.

New Zealand

After wet and cold conditions muted the recovery from last year's slow spring, extremely dry conditions have further hit New Zealand's milk production through the summer months. December 2017 milk intakes were around 2.5% lower than the same month in 2016, representing a change from the trend which had seen year on year growth peak at just over 4% in November. Rain in January may help arrest the decline, however there will be further impacts as a result of lower feed surpluses in spring reducing the volume stored as silage or hay.

Milk production grew by around 3% for the second half of the 2016/17 season, after a 3% fall in the first half. With a 1% increase chalked up for the first six months of 2017/18, the likelihood of a substantial growth against much stronger comparables for the balance of the season has been increasingly questioned. Fonterra is expecting an 8% fall over this period, resulting in a 3% full season fall (a small part of this represents loss of market share). Those of us who are more sceptical of pessimistic production forecasts from the kiwis take note of the still-attractive NZ\$6.40/kg MS (around A\$6.31/kg MS) farmgate milk price forecast on offer from Fonterra; which provides some incentive for farmers to squeeze more milk out of even a difficult season.

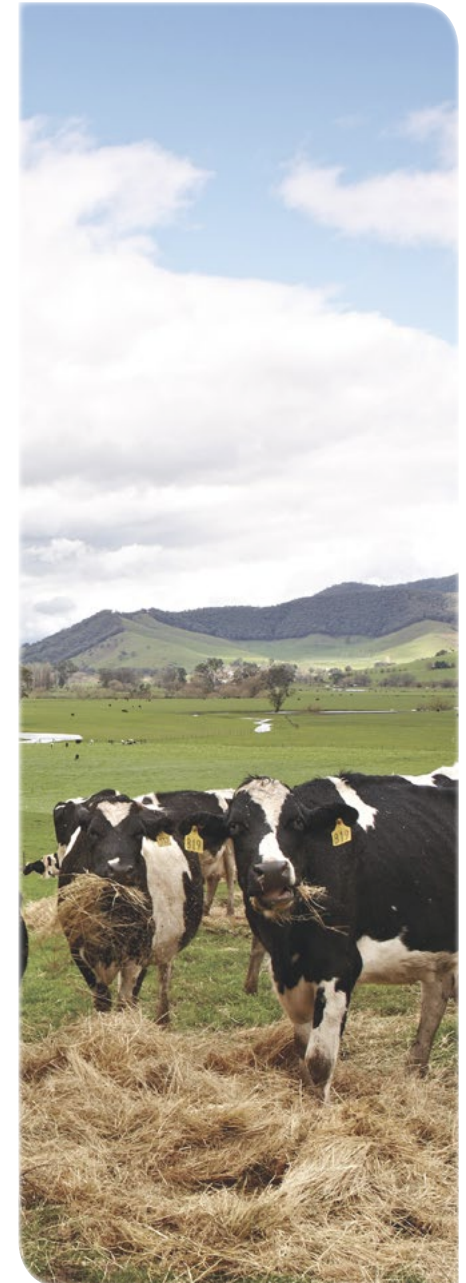
However, the bearish outlook for dairy commodity prices may yet flow through, and on the basis of price calculations from NZ-based analysts such as AgriHQ, \$6.40/kg MS may yet prove an optimistic forecast. AgriHQ have a much lower NZ\$6.09/kg MS forecast in mind, and see that driving production 1% lower than the full 2016/17 season total. That said, a recent round of published pessimistic outlooks helped spur GlobalDairyTrade prices higher – so a few more laps of the feedback loop may be required.

Australia

Australia's milk production is up nearly 3% for the first half of the 2017/18 season, reflecting a more favourable spring than 2016 in most regions, and incrementally higher milk prices. As envisaged in Dairy Australia's October Situation and Outlook report, this production growth is driven by southern, export-focused regions. For the season to December, farmers in Victoria, South Australia and Tasmania produced an average of 4% more milk than the same period in 2016, whilst southern NSW was flat in year-on-year terms. Northern Victoria has seen a particularly strong bounce from a very difficult first half last season, up 8% to December. Conversely, southwest Victoria remains subdued (up 0.5%).

Domestic-focused regions have seen profitability and (in some areas) seasonal challenges weigh on output over the same period. Milk production has fallen between 2- and 5% in northern New South Wales and Queensland, where dry conditions have added to the challenge of flat or lower milk prices. Western Australia has experienced somewhat milder weather, with production down almost 1% - although showing some growth in December.

Given stronger comparables and continuing challenges on-farm, it's likely that year-on-year growth rates will moderate during the second half of the season. With challenges looming in the international market, farmgate prices are more unlikely to change significantly for the balance of the season, and many farmers will hold off on further investment until a likely opening range for 2018/19 becomes clear. Assuming a modest slowdown from the current rate of growth, Dairy Australia's full season forecast remains an expansion of between 2- and 3% on the 2016/17 national milk production total, implying an outcome between 9.2 and 9.3 billion litres.



Corporate sector update

As reported in the last Situation and Outlook (October, 2017), there was widespread speculation regarding a potential takeover or merger of the beleaguered dairy cooperative, Murray Goulburn (MG), with confirmation of submitted offers expected at the Annual General Meeting on 27 October, 2017. In a surprise move at the AGM, MG's management announced a binding agreement to sell the cooperative's operating assets to rival Saputo for \$1.3 billion, with the unanimous recommendation of the MG board. This obviated the need for 90% approval from co-op members and depended on FIRB and ACCC approval. MG will retain all assets and liabilities associated with the listed MG Unit Trust, including all legal proceedings and associated settlement costs. MG has since settled with ASIC for \$650,000, however it also faces legal action from the ACCC and a shareholder class action.

At the time of writing, this transaction still requires the approval of the ACCC, with the provisional date for the ACCC's announcement moved from February 2nd to March 1st. Following regulatory approval, MG shareholders will vote on the proposal via an ordinary resolution, requiring a simple majority to pass.

In separate news, MG has sold its Edith Creek plant in northwest Tasmania to Thai-owned Dutch Mill, which owns several dairy farms in the region. Edith Creek, which produces UHT and specialty beverages, was one of three plants scheduled for closure as MG sought to reduce its cost base. The plant is expected to resume operation in early 2018.

Northern Victoria has seen considerable changes in milk processing and manufacturing since the last report in October. Murray Goulburn ceased production at its Rochester plant in January 2018, but has declined to give any indication of the future for the site. Meanwhile, Australian Consolidated Milk has announced plans for a greenfield milk processing facility in Girgarre in northern Victoria, with a total capacity on 200 million litres, and the capability to make both conventional and organic cheese, butter and milk powders.

Freedom Foods has announced further upgrades and expansion at its UHT facility in Shepparton. Formerly Pactum Dairy, a joint venture with Australian Consolidated Milk, Freedom Foods acquired the site outright, and has since invested in expanding capacity and streamlining operations at the

site. Freedom Foods has also reached an agreement with the newly formed Mountain Milk, a supplier co-operative in northeast Victoria, to supply an initial 20 million litres to the Shepparton facility.

Fonterra has also announced that it will spend \$125 million to expand production at the newly rebuilt Stanhope cheese factory, boosting production capacity from 45,000 tonnes to 80,000 tonnes. Stanhope was re-opened in August, 2017 following a fire which required the plant to be largely rebuilt. The \$125 million dollar expansion at Stanhope is part of a larger \$165 million investment package, aimed at increasing Fonterra's processing capacity in Australia by an additional 500 million litres.

In Western Australia, Archer Capital has sold Brownes dairy to a consortium of Chinese investors led by Shanghai Ground Food Tech, one of the largest cheese manufacturers in China. The current management team at Brownes will remain in place, however it is believed that the new owners will look to increase the scope for exports at Brownes, which is largely focussed on the West Australian domestic market.

Policy updates

ACCC Interim Report

On 30 November, the ACCC published the findings from its inquiry into the Australian dairy industry in an interim report. Key findings included:

- › There was a lack of competition between processors in most regions, leading to lower farmgate prices.
- › There was a fundamental power imbalance between processors and farmers when negotiating milk contracts, which deterred productivity growth and investment by dairy farmers.
- › Processors passed on a disproportionate share of market risk to farmers.
- › Domestic retail pricing strategies, in particular the one dollar per litre private label pricing strategy, are unlikely to have a direct impact on farmgate prices.

As a result of these findings the ACCC is exploring ways to improve market transparency, competition and make it easier for farmers to change processors. It has made an interim recommendation for the establishment and implementation of a mandatory code of conduct in the dairy industry, going beyond the voluntary code promulgated by the ADF. The ACCC is expected to hand down the final report on 30 April 2018.

Review of regulatory framework for Nutritive Substances and Novel Foods

The Australian and New Zealand dairy industries are highly innovative in their use of dairy products, which is the success of the dairy industry. Food Standards Australia and New Zealand (FSANZ) is currently reviewing the regulation of Nutritive Substances and Novel Foods, and the dairy industry continues to participate actively in the development and review of regulatory initiatives including FSANZ standards. The industry considers this is critical to responding to changing consumer needs, to supporting innovation and to leveraging the unique nutritional benefits of dairy foods for the benefit of consumers' health and wellbeing.



Health Star Rating system five year review

To help consumers recognise healthier foods, the Health Star Rating (HSR) system was introduced on packaged foods in 2014. The front-of-pack labelling system assigns a rating from 0.5 to 5 stars, based on the nutrition profile of the product, and was implemented on a voluntary basis for a five year period, with a review of the progress of implementation held after two years. The dairy industry supports the HSR system and its intentions to assist consumers to make healthy dietary choices. However, under the current system, some core dairy foods such as yoghurts and cheese score poorly (for example, some plain regular-fat Greek yoghurts score 1.5 stars). These ratings do not reflect current science nor the Australian Dietary Guidelines (ADG) recommendations.

The review commenced in mid-2017 and the Australian dairy industry has been engaged to ensure any changes to the HSR system recognise the health benefits of all milk, cheese and yoghurt.

To improve the HSR system and assist consumers to make healthy dietary choices, the dairy industry proposed three key recommendations as part of the review:

1. Improve the HSR for core dairy products scoring <3 stars through a policy consideration and/or adjustment to the HSR algorithm, with the aim of more closely aligning the HSR system with the ADG.

2. Based on high industry take-up, maintain a voluntary HSR system (as opposed to mandatory).
3. The Government develop a comprehensive public education health and nutrition campaign based on the ADG, with the HSR as the supporting tool.

The dairy industry will continue to participate in the ongoing HSR consultations in 2018.

New Trans-Pacific Partnership agreement signed

On 23 January 2018, the 11 remaining countries party to the Trans-Pacific Partnership (TPP) negotiations reached an agreement on the final text for the now Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) in Tokyo, Japan. The agreement, which includes Australia, Brunei Darussalam, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore and Vietnam is expected to be signed at a meeting of trade ministers in Chile on 8 March. Each country will then begin its domestic ratification process. The agreement will enter into force once 6 of the 11 countries have ratified and implemented the agreement.

Whilst there have been some changes to the text of the agreement, Dairy Australia understands that the market access outcomes for agriculture have remained unchanged, with the exception of outcomes related to

the US. The CPTPP provides minor improved access for Australian dairy to Mexico and Canada, with which Australia does not currently have any free trade agreements. However, where new Tariff Restrictive Quotas have been granted, these will also be shared with New Zealand. Both countries are also party to the NAFTA with the United States, whilst Canada has also concluded an agreement with the EU (CETA). Beyond north America, Australia already has free trade agreements with all other CPTPP members, so the immediate benefits are limited and incremental. However, given the quality of the agreement's architecture and the prospect of more countries joining further on, such as South Korea and Indonesia, there may yet be further benefits from the CPTPP.

For Australian dairy, the most important result of the TPP is the improved market access into Japan, Australia's biggest cheese market. Australia is currently the only major dairy exporter to have a free trade agreement with Japan (JAEPA), however the CPTPP represents a major improvement on JAEPA. The CPTPP provides for a phase out of some

tariffs on cheese, major liberalisation of whey powder access and the establishment of quota volumes for butter and milk powder, which were not included in JAEPA. Given the EU is currently negotiating a separate agreement with Japan, the CPTPP is also important for keeping Australian exporters competitive with EU sourced dairy products. An additional benefit of the CPTPP (vs the original TPP) is that the US withdrawal from the agreement removes the agreement's advantages from a major competitor for Australian dairy exporters.

Peru Australia Free Trade Agreement signed

On February 12th Peru and Australia signed the Peru Australia Free Trade Agreement (PAFTA), the quickest free trade agreement Australia has ever concluded. Both countries are also party to the CPTPP, however the bilateral agreement goes beyond the CPTPP in terms of market access and will likely enter force first. Both countries must now ratify the treaty before it can enter into force.



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