

EU Dairy Markets, Situation and Outlook, October 2014

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Highlights:

- Uncertainty resulting in falling prices has spread over the dairy markets in the EU and other major exporting countries. The reasons are the **growing milk output** of major exporting areas which seems to have outpaced demand. Moreover: the **import ban of Russia** imposed on the EU, U.S. and Australia has increased the nervousness.
- In Oceania and the EU many dairy companies have announced **reduced milk pay out** prices for the next months, which is the averse situation to just a year ago.
- Since mid2013 **milk production** in the EU and the United States is back to former growth after two years of reduced rates or even decline. Growth in Oceania continues.
- Nevertheless, the strong **growth** of the first half year, which in particular could be observed in the EU and New Zealand is likely to **slow down**. **In particular towards the end of the last quota year 2014/15 many dairy farmers in the EU will be forced to reduce milk sales since costly super levy payments are in sight.**
- Exports of **butter products, milk powders and whey derivatives** were **buoyant** in the first half of 2014 and grew to record levels. Towards the mid of the year milk powder and whey product exports fell below 2013 volumes. **EU exports of cheese have stagnated** at high levels, which is mainly due to the already longer lasting import bans on many cheese plants.
- The **Russian situation** is characterized by **stagnating or probably declining milk production**, which is mainly resulting from the falling numbers of small scale farms and self-subsistent households. The total import ban has been imposed on the major supplying countries, which cannot be replaced to the full extent by others and circumventing trade flows.

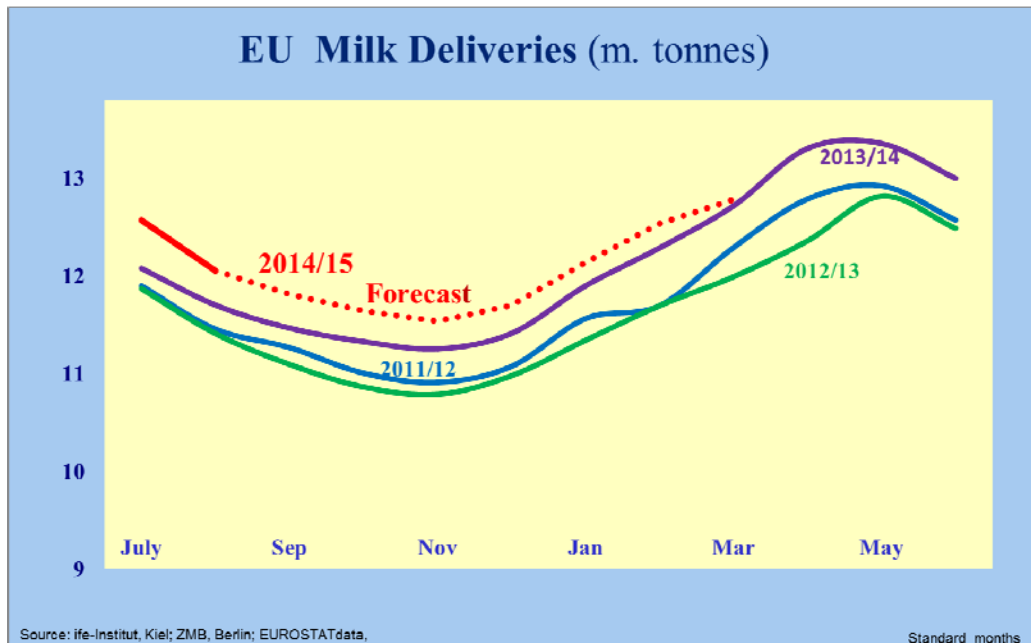
- **New Zealand** might take some **advantage** of the situation but Fonterra has to consider to which extent they might neglect other traditional costumers.
- On top of all the difficulties the uncertainty in the markets also results from other **political conflicts in the Middle East and Northern Africa**, which are major destinations for dairy exports, too.
- Beside these risks the fundamentals are still valid: World food and in particular **dairy demand will continue to grow**. The recovery of milk production since mid2013 in the major exporting countries so far has only temporarily outpaced the growth of demand, provided that growth can go on despite reduced Russian imports.
- **Lower prices** might be an **additional incentive** for demand from emerging markets. Lower prices of milk at the farm gate, however, reduce the margins and will accelerate the structural change by pushing away more farms with low profitability, which cannot be replaced in the same speed by new investments in larger scale dairy farms.
- Therefore there are prospects that markets might **regain a balanced situation** soon in terms of volumes, but...
- ...the question is when this can be transformed back to the market in a recovery from the bearish price situation. For a certain time ahead, **trading on a short term** from hand to mouth will cover a higher share of the business than it did in recent years.
- The **EU Commission** has announced **support measures** to help the European dairy industry to prepare to the new situation: Private storage of butter and cheeses are supported. **Intervention** of butter and SMP will be possible until December 31, but only at significantly lower prices than are quoted at present.

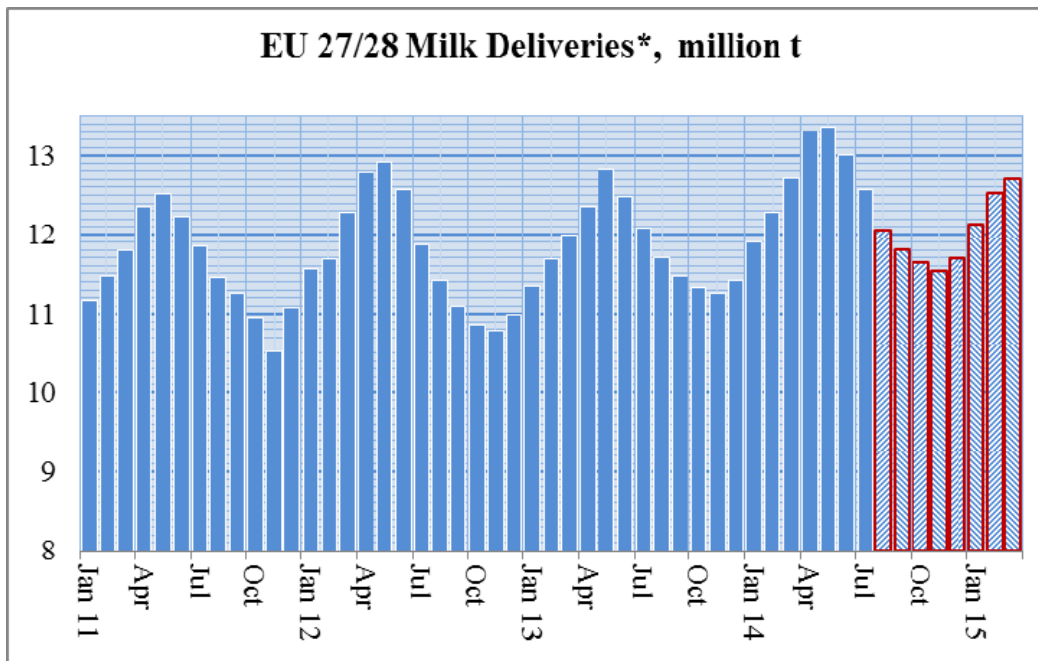
Slower expansion of EU milk production, but still substantial

EU milk supplies have declined seasonally since the end of May, but the cyclical expansion is still going on. The growth rates have slowed down, but not as fast as has been expected. In most areas plenty of rainfalls and moderate summer temperatures have led to favourable supplies of basic feedstuffs, which can be added by concentrate feed at reduced prices. Moreover, favourable milk prices

until July were attractive to farmers to keep milk production at high levels. In the seven months ended July, 88,4 m. t. of cow milk were delivered to EU dairies, 4,2 m. t. or 5,0%, respectively. Growth rates could be observed in most of the member countries, in particular in those where milk deliveries had been reduced in the first half of 2013. When in the mid of the year the rates declined in some Western, they accelerated in some Eastern member states. In the Netherlands and Denmark milk deliveries were already down to or even below 2013 volumes in August and early September, which is obviously a first reaction to the prospects of weaker milk prices combined with increased super levy payments (in some countries the highest ever!) at the end of the last quota year. Nevertheless, it seems to be likely that milk deliveries will continuously exceed previous quantities, but at lower rates.

Overview of EU milk deliveries in 12months periods





*)January 2011/July 2014 and estimate August 2014/ March 2015, adjusted for average length of months.

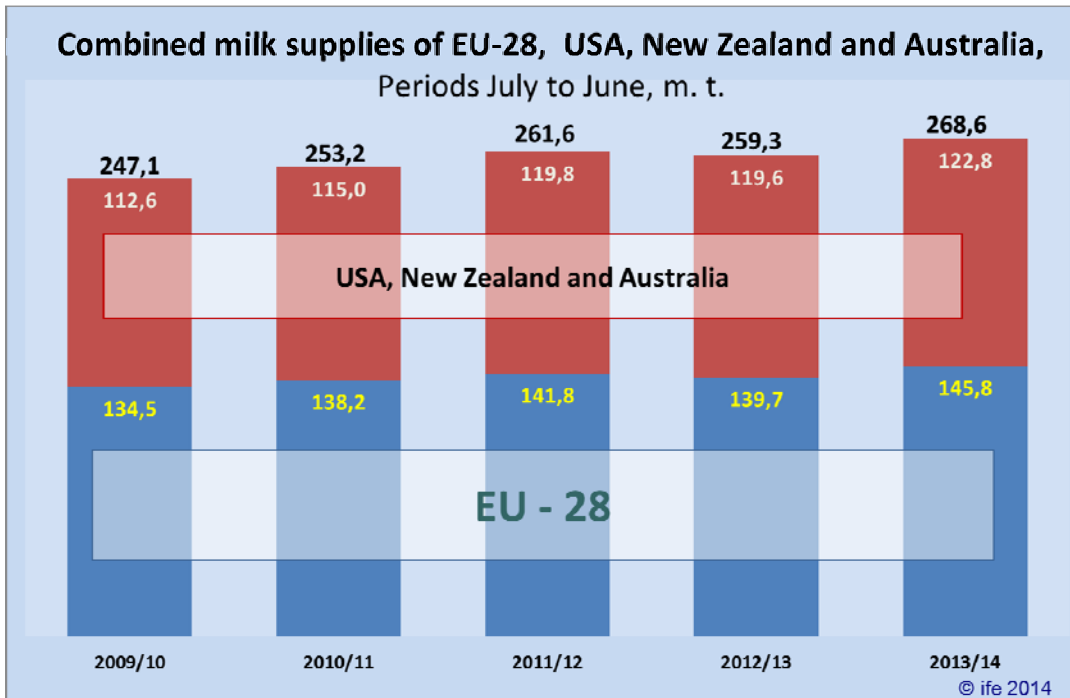
Aiming at reducing the super levy payments, many European dairy farmers will try to adjust milk deliveries down by different ways. But most of them have to be prepared for the start into the new era free of quotas with their full production capacity. Consequently the options to run down milk deliveries are limited: using whole milk for calf rearing, culling older cows and reduced concentrate feeding are some of the options. The structural change might accelerate in the way that farmers who intend to stop dairy farming do so earlier than they would have done under the favourable circumstances of early 2014. On the other hand, it is unlikely that ongoing new investments in dairy farming will postpone their start of milk production to April, 2015.

Under these conditions we estimate for the time from August to December 2014 another increase of 2 m. t. of milk supplies, ending up with around 148 m. t. of cow milk deliveries in the 28 EU member states for the whole year which is 6m. t. more than in 2013. A similar increase could be observed in the 12-months period ending June 2014. This increase had followed a 12-months period with ongoing decline, which had ended June 2013. Thus EU milk production had resumed its former growth speed and made good what had been failed the period before. But it is unlikely that it will continue to grow at the same speed as it did since mid2013.

More milk also in other major exporting areas

Less distinct, but also in the U.S. milk production had started its cyclical expansion in mid2013, and like in the EU when it went down seasonally. In Oceania, the season 2013/14, which began in New Zealand in June and in

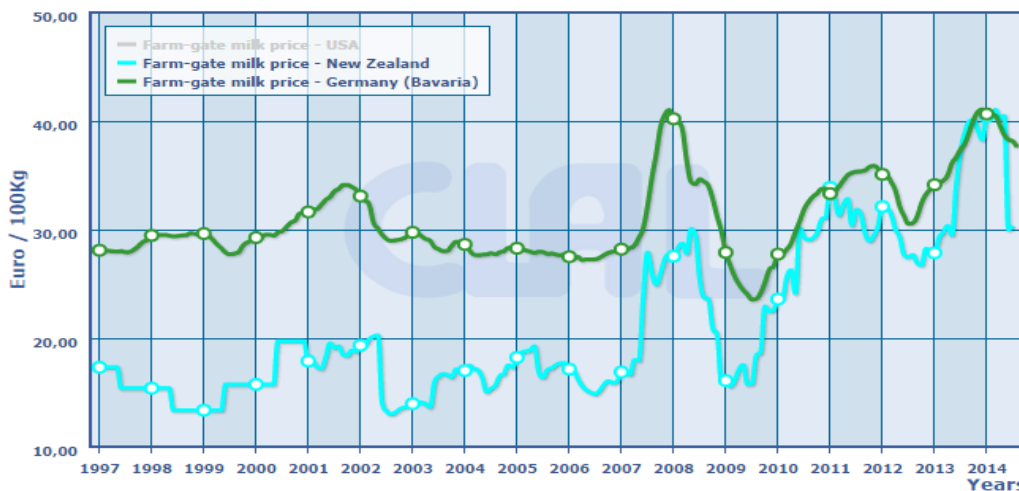
Australia in July 2013 showed a strong recovery compared to the previous season, in particular in New Zealand. For both Oceania countries around 5% increases are reported under good natural conditions in the new season, which, however can change depending on weather. The latest figures which are available indicate a constant expansion in the United States in the size of just below 2%.



The economic conditions, however, have become worse since prices are under pressure. Many dairy companies in the EU and in Oceania have reduced the farm gate milk prices or announced significant reductions. This resulted from falling prices of the major dairy commodities which are traded internationally, which will have also increasing impacts on domestic prices within the EU.

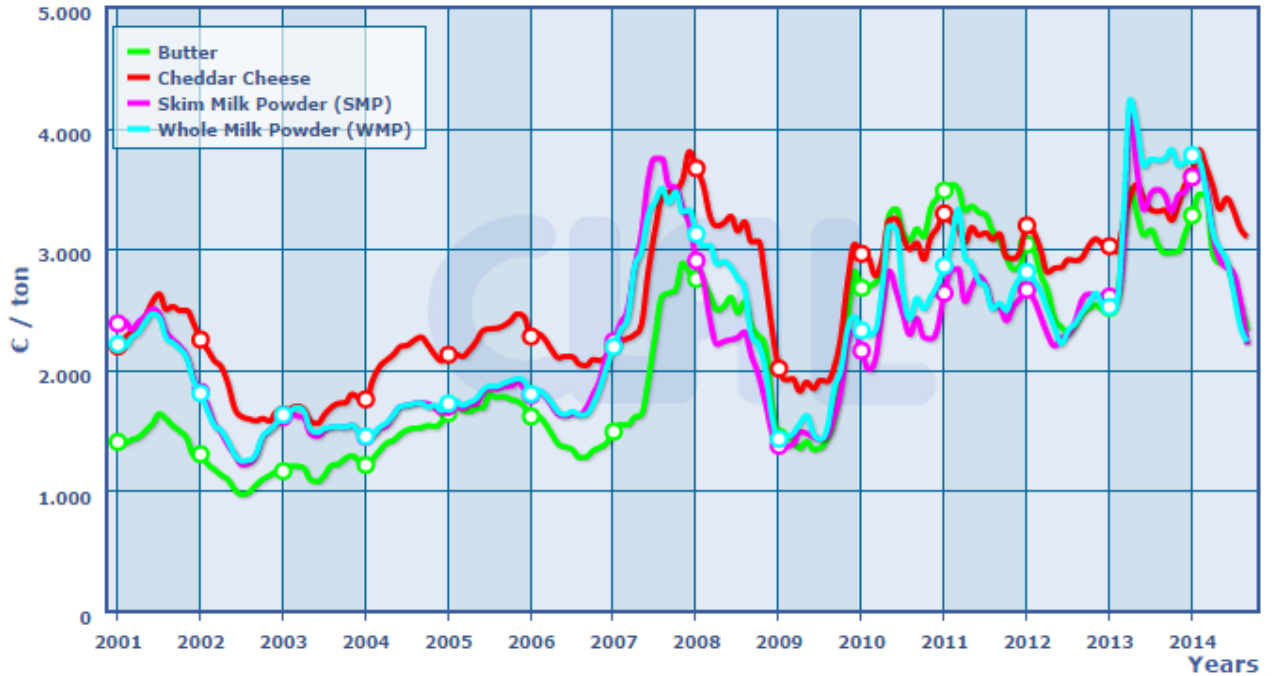
Historical comparative overview on Farm-gate Milk prices in Bavaria (D), the US, New Zealand

Processed by CLAL



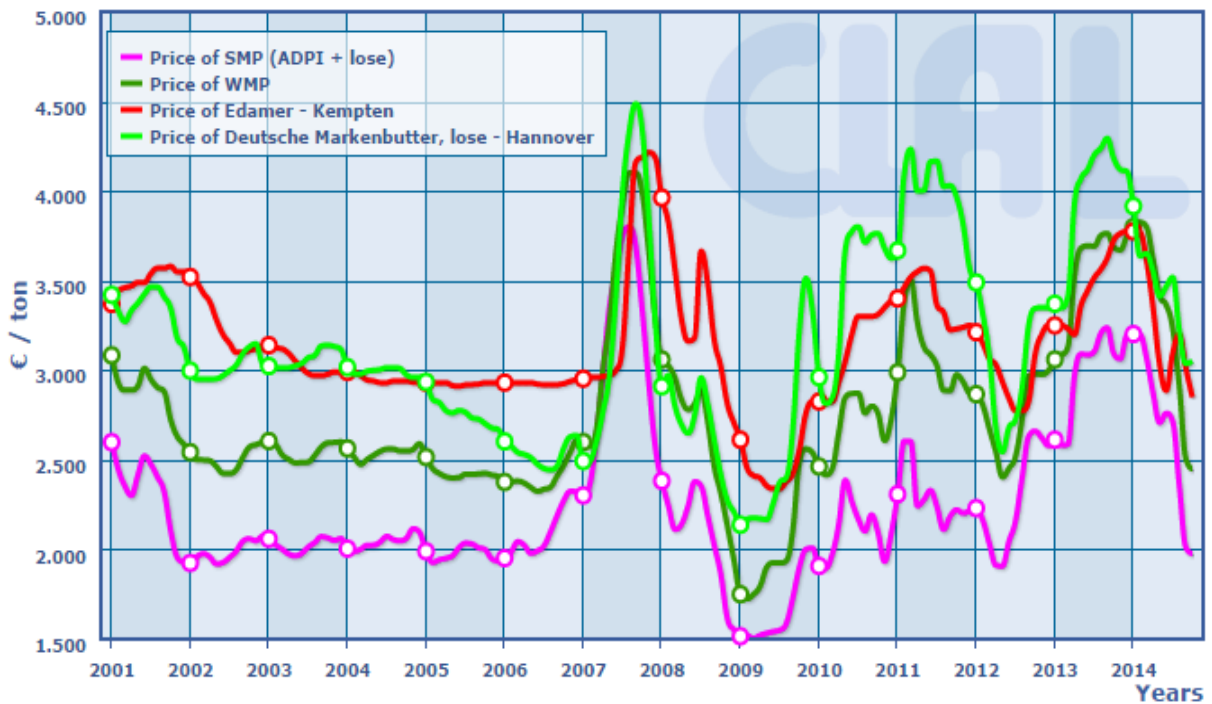
OCEANIA - Price comparison among BUTTER, CHEDDAR, SMP, WMP (€ per Ton)

Source: USDA AMS Dairy Markets News



GERMANY: Comparison among Butter, Edamer, WMP and SMP prices (€ per Ton)

Source: ZMP; from May, 6th 2009: Sudeutsche Butter - und Kasebörse eV, Kempten



After a relatively long period of strong prices the turn of the markets came faster than had been expected, for the following reasons:

- The ongoing increase of milk supplies, which remained longer than initially expected
- The temporarily reduced demand after buoyant export/import activities in the second half of 2013 and the first half of 2014 (corresponding to the strong increases of supplies)
- Rumours about large inventories of milk powders in China, which has become the predominant importing country
- The ban imposed by Russia on imports following the soaring political conflict about Ukraine
- The uncertainty created by the political conflicts in the Middle East and Northern Africa

The situation in Russia

Since August 7th imports of many food items into Russia including dairy products listed in the Combined Nomenclature from 0401 to 0406 (fresh milk, milk powders, fermented products, whey, butter and cheese) originating from the EU, Norway, the USA, Canada and Australia are banned. However, it is unlikely that on the short term the Russian dairy industry and the remainder of major international exporting countries can replace the banned origins. To some extent a change of trade flows might fill parts of the gap by increasing supplies from New Zealand, Argentina, Belarus and other countries, however with only small potentials. Also products manufactured from milk concentrates and cream originating from banned countries to Belarus and Kazakhstan might contribute to ease the short supply situation in Russia. The Russian dairy industry has gained competitiveness and might become more profitable due to higher domestic prices, but it cannot immediately boost sales volumes since milk production is stagnating. The ban will drive the food price inflation in Russia, together with the effect of the devaluated Rouble, which has lost 25% of its value against the US-Dollar and the Euro since January 2013. Anyway, Russian consumers will have to live with reduced and more expensive dairy product supplies. The EU and other countries have to cope with reduced export opportunities to this destination, and the Russian market will not be the same as it used to be, even if once the bans should be lifted.

Table 1

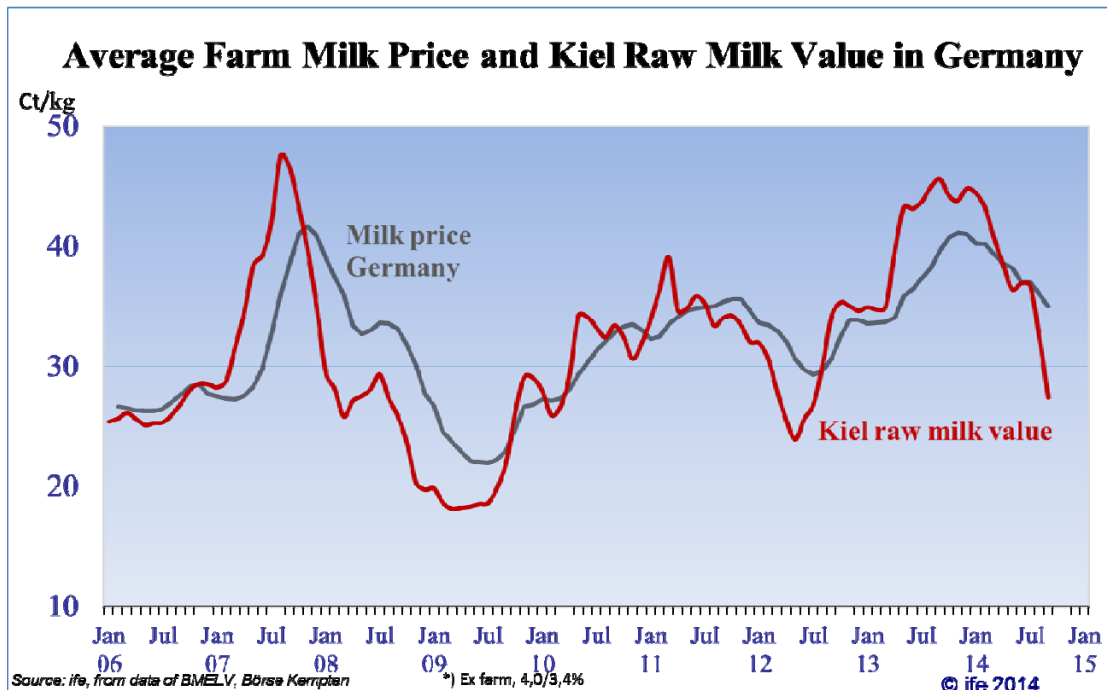
| Russia/ EU: Key figures (1.000t) | | | | | |
|---|--------------------------|--------------------|----------------------|--|----------------------|
| | Domestic production 2013 | Total Imports 2013 | Imports from EU 2013 | Share of Russia in total EU exports 2013 | EU-market share 2013 |
| Cheese | 455 | 439 | 257 | 33% | 29% |
| Butter | 210 | 144 | 35 | 24% | 10% |
| SMP | 55 | 110 | 20 | 18% | 12% |
| WMP | 65 | 34 | 2 | 1% | 2% |
| Whey powder | n. a. | 135 | 22 | 16% | n.a. |
| Food preparations | n. a. | n. a. | 106 | 9% | n.a. |

Source: EU Commission

New Zealand will be inclined to serve the extra Russian demand mainly from the additional milk volumes. The other overseas options for Russia are only Argentina and Uruguay; but there dairy industries have other growing Latin American markets at their doorstep. Their combined milk production was below 10 million t in 2013.

Reaction in the EU

The Russian measures were obviously the final indicator to confirm the downward direction of price developments which so far had not been quite clear. Some productions of cheeses which had been produced for the Russian market had to find other outlets, and thus the recovery of semi-hard cheese prices was stopped and reverted. Cheese production had to be reduced, milk had to be directed to other utilisations – mainly butter and SMP, which also came under pressure. Thus also those parts of the milk processing which were not producing for Russia had to cope with the impacts by the of falling commodity prices. The return of milk processing into the commodities butter and skim milk powder, as displayed in the Kiel Raw Milk Value (defined ex farm per kg of raw milk with 4,0% fat and 3,4% protein), fell 5,1 to 27,4Ct in September, which was 18Ct below the record level of September 2013. Although it is not determining the value of all utilisations and the farm milk prices, it indicates their direction. When prices of cheese and the range of liquid products for the retail follow, the comparable farm milk prices in the major North Western countries of the EU might come down to fluctuate around 30Ct/kg in the next months and possibly until mid2015.



The EU Commission introduced emergency measures to support the dairy industry in dealing with immediate surpluses by offering aids for the private storage of butter, cheese and skim milk powder, which are limited to December 31, 2014. Some volumes have been taken into stores under this programme. The question is whether that is sufficient to bridge the time until demand from international markets has recovered. Also the period for intervention of butter and skim milk powder has been extended until December 31. But since market prices are significantly above the reference (intervention) prices, intervention is not an option yet.

Changes in milk processing

In the first seven months of 2014, milk processing had been driven by the increase of milk supplies, buoyant exports and an almost stagnating domestic market; that resulted in substantially larger productions of milk powders, a small increase of butter and cheese output, with the latter more driven by milk supplies in the spring flush season than by demand. This will change for the remainder of this year and possibly later: Less milk has to be used for cheese manufacturing within the EU, more than in the second half of 2013 will be used for butter and skim milk powder. Also increasing volumes of bulk milk, milk concentrate and cream will be shipped for further processing to countries outside the EU which are not under the Russian import ban. A fast growing export outlet is selling UHT milk and other liquid and fresh dairy products to China, which will continue to boost production in this sector. But the raw milk volumes used for these attractive outlets are small in relation to the milk powder sector and the expected additional milk deliveries.

Table 2

| Key figures of the EU dairy market, Jan./July | | | | |
|--|-----------------------|-----------------------|----------------------|------------------------|
| Milk supplies | 2013 in m.t | 2014 in m.t | 2014vs. '13 m.t** | 2014vs. '13 % chge. |
| - Deliveries | 84,109 | 88,352 | +4,2 | +5,0% |
| Dairy products | 2013 in 1.000t | 2014 in 1.000t | 2014/'13 1.000t** | 2014/'13 % |
| Butter | | | | |
| - production* | 1.001 | 1.035 | +34 | +3,4% |
| - imports | 29 | 37 | +8 | +29% |
| - exports | 73 | 92 | +19 | +27% |
| Cheese | | | | |
| - production* | 4.365 | 4.432 | +67 | +1,5% |
| - imports | 44 | 50 | +6 | +15% |
| - exports | 453 | 453 | -0 | 0,0% |
| WMP | | | | |
| - production* | 322 | 384 | +62 | +17% |
| - exports | 217 | 246 | +29 | +13% |
| SMP | | | | |
| - production* | 593 | 786 | +54 | +9,6% |
| - exports | 239 | 382 | +133 | +60% |
| *) January - June. **) Small differences due to rounding. | | | | |
| Sources: ife, Kiel; ZMB, Berlin; European Milk Market Observatory, Brussels. | | | | |

The present market situation has increased the attitude of potential buyers to limit their orders more to short term needs. This attitude is supported by the prospective seasonal growth of milk production in major producing areas of the Northern hemisphere in December.

On the other hand, sellers are confident with regard to the ongoing growth of the global market. Therefore they are more reluctant to accept long term contracts at significantly lower prices. Nevertheless, it seems to be likely that the cycle phase of lower prices will hold on until the mid of 2015, with milk prices in the EU, as already mentioned, moving around 30Ct/kg. Recently Fonterra has predicted a milk price, transformed from 5,30NZD/kg of milk solids to European standards of 26Ct/kg for raw milk in the season 2014/15, which is one third less than the confirmed pay-out of 39Ct in 2013/14.

The prospects of lower prices might bring back the global market to a more balanced situation, because they are an incentive to more demand, whereas the speed of expanding of milk production will slow down.

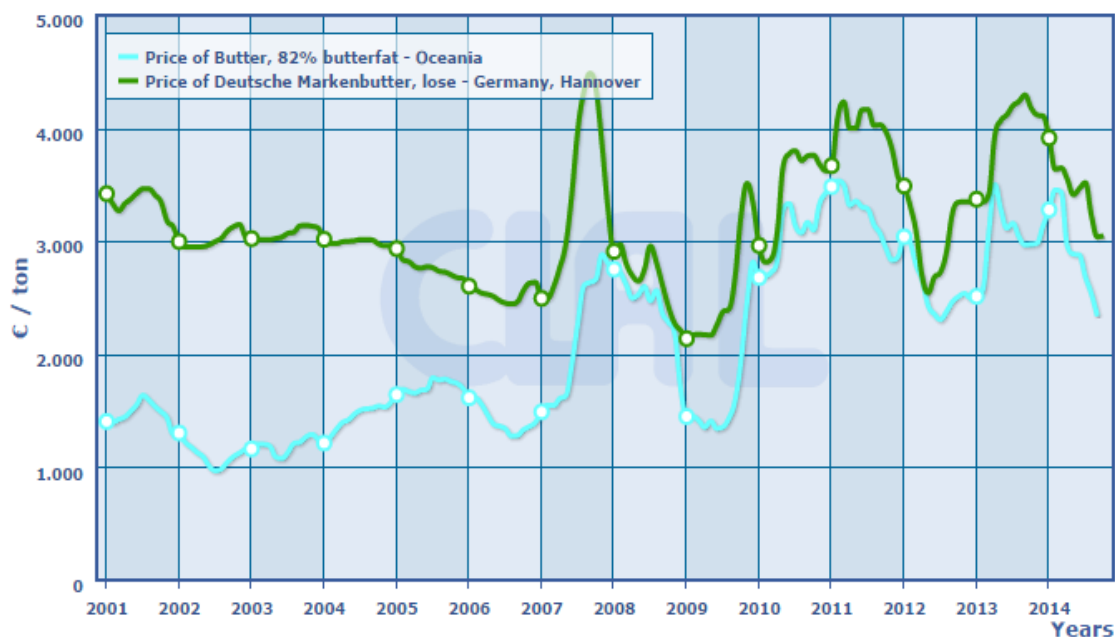
EU butter prices down and closer to World market levels

In the EU and Oceania, butter prices have continued to fall until the end of September. EU production has not been reduced according to the seasonal decline of milk supplies, since the milk volumes for cheese manufacturing have been reduced in the summer and now also as consequence of the Russian import ban. On top, also butter exports to Russia had substantial volumes which are no more possible. And since decades it was the first time in 2014 that no aids under the private storage scheme (PSA) have been offered in spring to take butter into private stores. Now the emergency measures of the EU supporting storage of butter until the end of the year seem to have stopped the downward price movement at the end of September. Anyway, to bring more stability into the butter market in early 2015, an early announcement by the EU Commission to support the butter market by storage aids already in spring would be helpful.

In general, the butter sector again proves to be the part of dairy markets with the highest volatility of prices. Nevertheless, European price levels are still above the world market. More than 70% higher are the prices in the United States, and it might be a question of time that they will import from the international market, after having exported growing quantities in the first half year.

**Comparative historical overview between Butter prices
 in Oceania and Germany**

Processed by CLAL

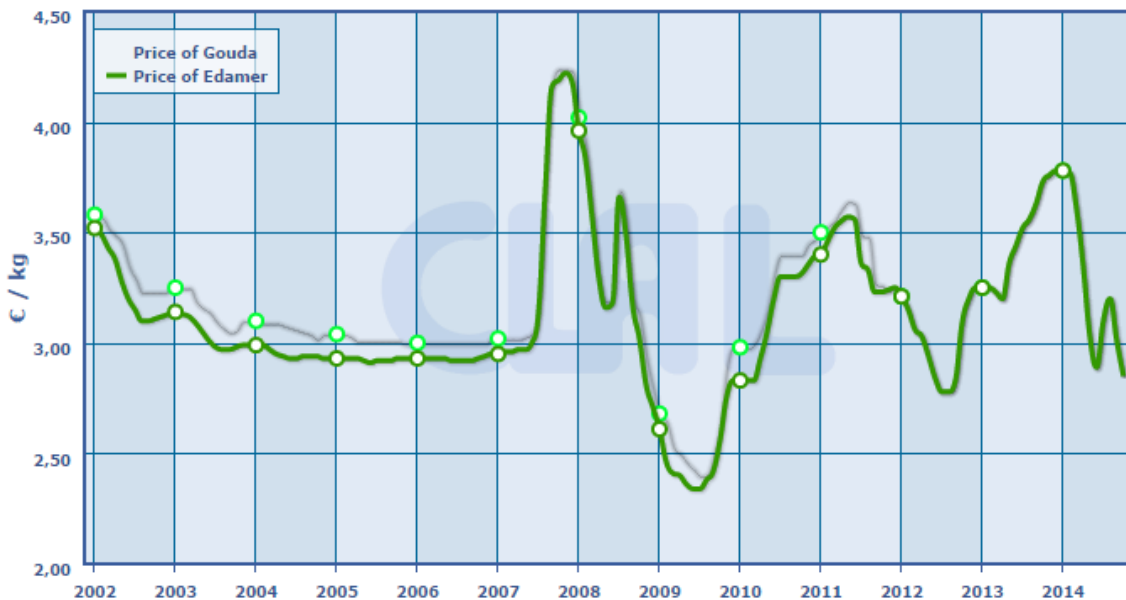


Only short time recovery of cheese prices

As cheese production grew, but exports could not be expanded, more semi-hard and hard cheeses had to be taken into stores, in particular in the time of the seasonal milk flush in spring. However, the endeavours to clear the surplus stocks in ripening stores were thwarted by the Russian import stop ending up in falling prices after a short recovery. Storage aids have been applied for over 100.000t of cheese under the EU emergency support programme until September 21, of which 84.000 have been applied for in Italy. As of September 23, this measure has been suspended for cheeses.

Germany, Kempten - Historical comparative overview of prices of Gouda and Edamer

Source: ZMP; since May, 6 2009: Süddeutsche Butter- und Käsebörsen eV, Kempten



More milk powders

EU milk powder production has been extended significantly, since exports have been boosted in the first seven months of 2014. Already towards the end of that period exports declined. In the following months the cyclical expansion of skim milk powder production will continue since large volumes of milk have already been and will be withdrawn from cheese manufacturing. For whole milk powder, it is not clear yet whether EU production will continue to be above 2013 volumes.

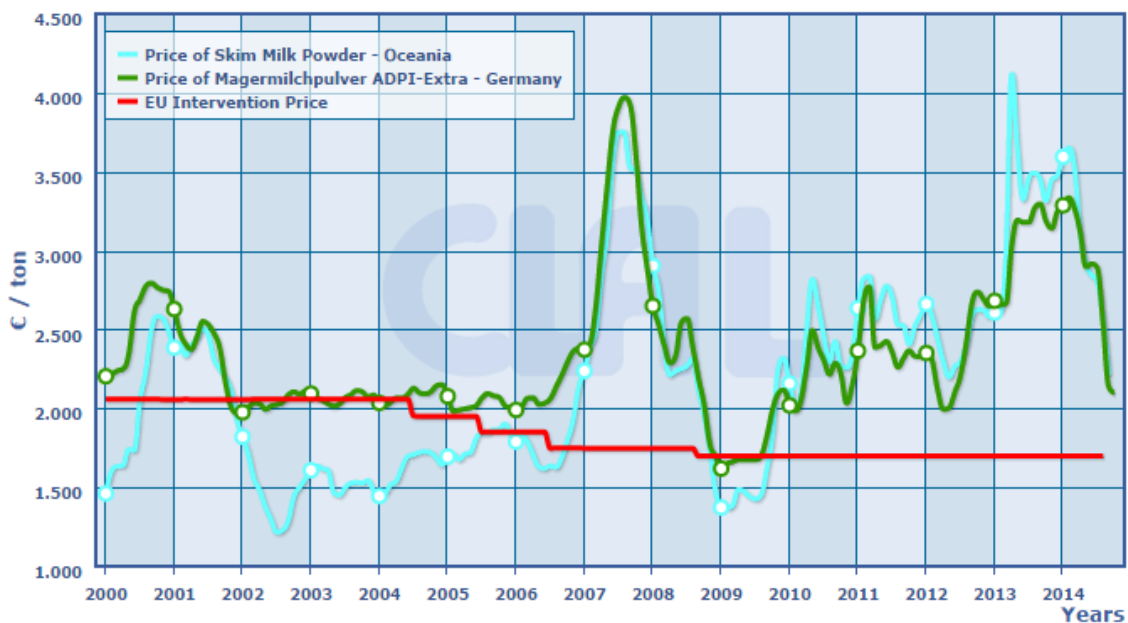
Increased supplies of skim milk powder can be taken into stores under the EU support scheme for private stocks which is scheduled until the end of December. For only small volumes the storage aids have been applied so far. Intervention, if necessary, will be open also for packages up to 1.500kg (big bags).

Major destination of both milk powder types has been China. When China will be back to the market again with larger and longer term orders, however, is not

clear yet. EU suppliers of skim milk powder are in a good competitive position after the recent price reductions and with the weaker Euro rate. Demand for skim milk powder will benefit from the lower prices. Only in the sector of milk replacers for the rearing of young calves demand is expected to decline as more whole milk will be used by farmers for this purpose instead of sending it to the dairy companies, if these deliveries are threatened by the super levy.

Comparative historical overview between SMP market prices in Germany and Oceania and EU intervention price

Processed by CLAL



Comparative historical overview between WMP prices in Germany and Oceania

Processed by CLAL

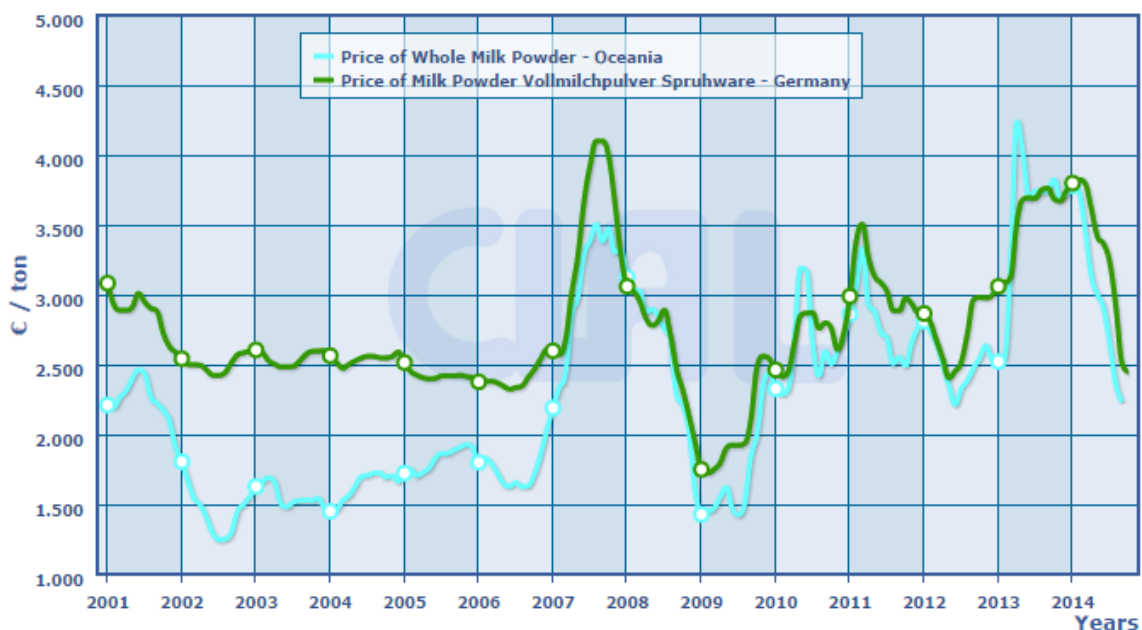


Table 1

EU- Dairy Market 2009 - 2013 and Forecast 2014

| 1.000 t | 2009 | 2010 | 2011 | 2012 | 2013* | 2013** | 2014** |
|-------------------------------|---------|---------|---------|---------|---------|--------------------|---------|
| | EU 27 | EU 27 | EU 27 | EU 27 | EU 27 | EU 28 | EU 28 |
| Milk deliveries | 134.702 | 136.666 | 139.526 | 140.234 | 141.200 | 141.701 | 148.000 |
| Liquid Products | 44.157 | 44.440 | 44.555 | 44.850 | 44.780 | 45.080 | 45.000 |
| Butter | | | | | | | |
| Production | 2.050 | 2.010 | 2.080 | 2.105 | 2.111 | 2.115 | 2160 |
| Consumption | 1.984 | 1.974 | 1.966 | 2.013 | 2.021 | 2.027 | 2040 |
| Cheese | | | | | | | |
| Production | 9.333 | 9.497 | 9.611 | 9.700 | 9.810 | 9.840 | 9830 |
| Consumption | 8.840 | 8.908 | 8.993 | 9.007 | 9.101 | 9.135 | 9155 |
| Skim Milk Powder | | | | | | | |
| Production | 1.160 | 1.080 | 1.220 | 1.230 | 1.200 | 1.200 | 1.400 |
| Consumption | 800 | 805 | 810 | 810 | 797 | 800 | 820 |
| WMP Production | 735 | 760 | 750 | 715 | 730 | 730 | 740 |
| Population m. head | 500 | 501 | 502 | 504 | 505 | 510 | 511 |
| *) Provisional. **) Forecast. | | | | | | September 22, 2014 | |

Sources: ife, Kiel; ZMB, Berlin.

Table 2

EU Butter Balance Sheet

| 1.000 t | 2009 | 2010 | 2011 | 2012 | 2013* | 2013* | 2014** |
|-----------------------------|-------|-------|-------|-------|-------|------------------------|--------|
| | EU 27 | EU 27 | EU 27 | EU 27 | EU 27 | EU 28 | EU 28 |
| Production | 2.050 | 2.010 | 2.080 | 2.105 | 2.111 | 2.115 | 2.160 |
| Imports | 62 | 40 | 47 | 56 | 45 | 45 | 50 |
| Exports | 143 | 161 | 132 | 128 | 135 | 133 | 130 |
| Final stocks | 135 | 50 | 80 | 100 | 100 | 100 | 150 |
| Consumption | 1.984 | 1.974 | 1.966 | 2.013 | 2.021 | 2.027 | 2.040 |
| *)Provisional. **)Estimated | | | | | | ife September 22, 2014 | |

Sources: ife, Kiel; ZMB, Berlin; EU Commission

Table 3

EU Cheese Balance Sheet

| 1.000 t | 2009 | 2010 | 2011 | 2012 | 2013* | 2013* | 2014** |
|-------------------------|-------|-------|-------|-------|-------|-------|--------|
| | EU 27 | EU 27 | EU 27 | EU 27 | EU 27 | EU 28 | EU 28 |
| Production | 9.083 | 9.237 | 9.366 | 9.465 | 9.570 | 9.600 | 9.600 |
| Imports | 85 | 82 | 74 | 78 | 76 | 78 | 80 |
| Processed cheese impact | 250 | 260 | 245 | 235 | 240 | 240 | 230 |
| Exports | 578 | 676 | 682 | 776 | 790 | 788 | 730 |
| Stock change | +0 | -5 | +10 | -5 | -5 | -5 | 25 |
| Consumption | 8.840 | 8.908 | 8.993 | 9.007 | 9.101 | 9.135 | 9.155 |
| -per capita (kg) | 17,7 | 17,8 | 17,9 | 17,9 | 18,0 | 17,9 | 17,9 |

*)Provisional. **)Estimated ife September 22, 2014

Sources: ife, Kiel; ZMB, Berlin; EU Commission

Table 4

EU SMP Balance Sheet

| 1.000 t | 2009 | 2010 | 2011 | 2012 | 2013* | 2013* | 2014** |
|-------------------|-------|-------|-------|-------|-------|-------|--------|
| | EU 27 | EU 27 | EU 27 | EU 27 | EU 27 | EU 28 | EU 28 |
| Production | 1.160 | 1.080 | 1.220 | 1.230 | 1.200 | 1.200 | 1.400 |
| Imports | 6 | 4 | 0 | 2 | 5 | 5 | 2 |
| Exports | 227 | 378 | 518 | 523 | 413 | 410 | 550 |
| Final stocks | 359 | 260 | 152 | 50 | 45 | 45 | 90 |
| - in intervention | 260 | 195 | 54 | 0 | 0 | 0 | 0 |
| Consumption | 800 | 805 | 810 | 810 | 797 | 800 | 820 |
| - as Feed | 160 | 165 | 175 | 160 | 120 | 120 | 130 |

*)Provisional. **)Estimated ife September 22, 2014

Sources: ife, Kiel; ZMB, Berlin; EU Commission

Table 5

EU WMP Balance Sheet

| 1.000 t | 2009 | 2010 | 2011 | 2012 | 2013* | 2013* | 2014** |
|--------------------|-------|-------|-------|-------|-------|-------|--------|
| | EU 27 | EU 27 | EU 27 | EU 27 | EU 27 | EU 28 | EU 28 |
| Production | 735 | 760 | 750 | 715 | 730 | 730 | 740 |
| Imports | 2 | 2 | 2 | 2 | 3 | 3 | 5 |
| Exports | 463 | 447 | 390 | 396 | 394 | 394 | 435 |
| Stock change | -55 | -20 | 10 | 0 | 0 | 0 | 0 |
| Consumption | 329 | 335 | 352 | 321 | 339 | 339 | 310 |

*)Provisional. **)Estimated ife September 22, 2014

Sources: ife, Kiel; ZMB, Berlin; EU Commission