dairyglobe

International edition

9 August 2017

A newsletter from Freshagenda of major events in international dairy markets

Highlights

- **US exports continued to build in June**
- **Improving milk flows in Europe**
- **Cheese, powder surged in June but where's the fat?**
- **Westland raises payout**
- **Chinese investment in Canadian formula plant**

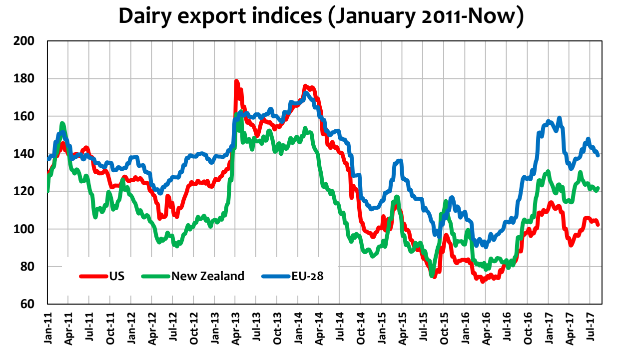
What we are seeing this week

Europe's milk supply is building again, with gradual release of June production numbers showing steadily improving output, which will only get stronger after summer months given the 4th quarter slump last year. The US continues to pump out more milk but that country's trade numbers released this week showed that while the world market continues to have plenty of appetite for cheese, expansion of demand for cheap protein may not be there to soak up the additional milk that is on the way.

We'll have to wait a couple of months to find out either way – most of the key players in Europe are on the beach with their minds on anything but dairy markets!

International dairy export indices

Our international dairy export indices were mixed this week. The NZ index rose 1.4 points 122, while the EU-28 index shed 2.2 points to 139. The US index climbed 2.3 points to 102.



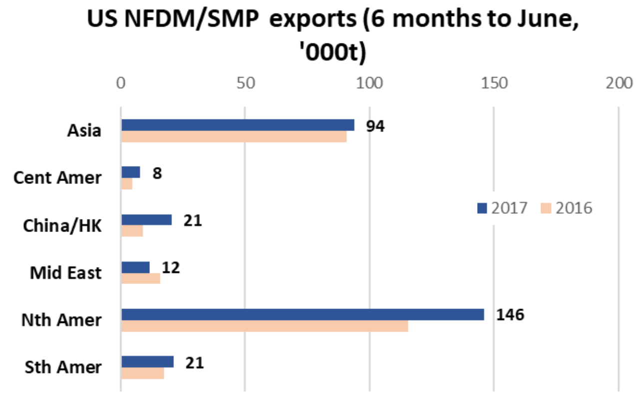
Take note: These indices track the trends in gross export returns to each of the three major exporting dairy industries, based on quoted spot prices, currency values and product mix in exports from each of the big 3. Essentially the index is of the weighted value of exports to each industry in their home currencies, set at 100 on 1 January 2007.

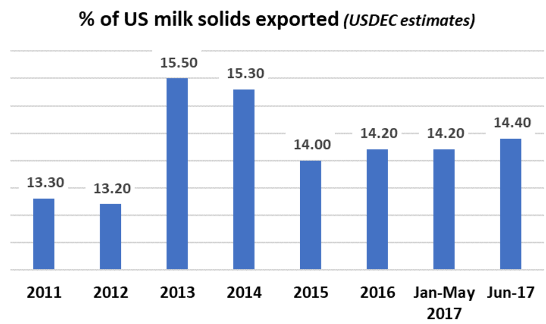
Global dairy markets

US exports continued to build in June – US **cheese** exports continue to take advantage of favourable US pricing against competitors (according to latest prices from spot quotes) and were 32% higher in June compared with the same month last year, taking the first half total 24% above the comparative. Cheese exports represented 6.2% of total US production in the first half of 2017, ahead of the 5.1% a year earlier.

On the flip side, growth in trade of combined **non-fat dried milk (NFDM) and SMP** exports slowed and was only 7% above the same month last year, after being 20% in the first half of the year. Mexico continues to prop up US trade in milk powder. With a 39% jump in trade in the latest month which represented close to half US exports for the month, sales to Mexico in H1-2017 were up 27% over H1-2016. **Whey product** exports fell by 10% in June for the first time in the past year, mirroring the fall in sales to China. First half shipments were 12% higher than H1-2016, while Chinese shipments were up 43%. But with China's demand slowing and production remaining strong, whey powder markets are weaker in the US.

Butter exports remain small (just a little over 10,000t in the first half of 2017), but rose almost 4-fold in year-on-year terms in the month, but were only 13% higher for the first half of 2017.



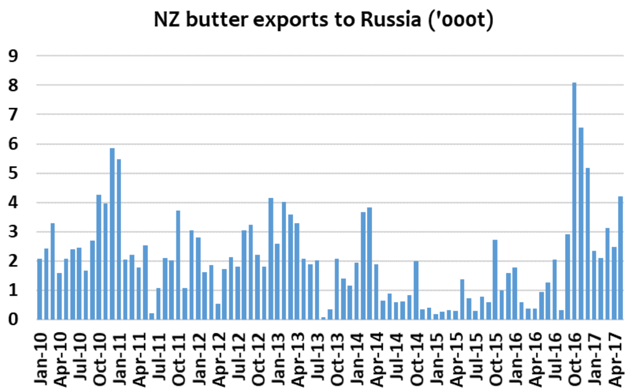


China release first 30 IMF brands approved for import – The China Food and Drug Administration (CFDA) has approved the first 30 brands of infant formula for imports from 1 January 2018. The 30 brands are made in 22 infant formula factories owned by 14 manufacturing companies. Fonterra Australia's joint venture partner in a powder plant at Darnum, Beingmate has had a total of 12 formulas of baby and infant formula from its factories approved for registration. New Zealand-based Synlait and a2 Milk Company announced to the NZX and ASX that they missed the first list but were still confident their application to export a2 Platinum infant formula to China would be approved.

Australia's exports for June – Despite the 7% slump in milk output, total Australian dairy exports fell just 2.4% in the 12 months to June 2017, helped by overall cheese exports which were 2.6% lower for the year. But there has been a large shift in mix of powder trade following the priorities of manufacturers based on the weaker protein market with SMP shipments down 15% to 153,425t and WMP sales up 13% to near 87,000t – the highest shipped tonnage of WMP since 2013/14.

Canada's dairy processors disappointed – Canadian dairy farmers and processors are disappointed in the federal government, who they claim has failed to allocate import licenses to those cheesemakers, who would import cheeses that aren't already produced in Canada. The new tariff rate quotas (TRQs) will see almost 18,000kgs of European cheeses enter the Canadian market tariff free under the trade agreement, CETA between the two regions. While both Dairy Processors Association of Canada and Dairy Farmers of Canada say these changes will flow through to dairy farmers who will produce less milk, the Canadian government launched two programs worth CA$350m to support farmers and processors. A CA$250m five year fund to provide up to CA$250,000 to support producers in upgrading their technology and equipment and a four year CA$100m program to support capital investment projects for dairy processors.

Russia's butter complaint mystifies NZ – New Zealand government officials are baffled by the repeated discoveries of tetracycline in NZ butter by Russian veterinary service Rossellkhoznadzor, especially as tetracycline has not been registered as a veterinary medicine for farm animals in NZ since 2011. According the Ministry for Primary Industries, the ministry continued to engage with Russia following the latest discovery, which marked the fifth discovery of tetracycline in two years.

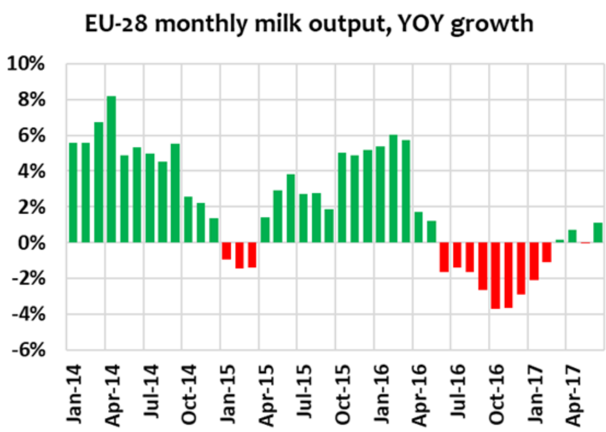


However, despite the discoveries and threats of a ban on NZ dairy imports, in the final three months of last year NZ sales of butter to Russia was the highest on record in NZ$ terms for any quarter in two decades. According to diplomats, the warming between Belarus and Russia could potentially squeeze NZ out of the market, however, the nature and scale of Fonterra's trade with Russia wouldn't cause concerns about domestic market disruptions.

EU dairy market and policy

Improving milk flows in Europe – The progressive updates to milk collection data posted by the European Commission through Eurostat suggests we'll see a stronger lift in June milk output than earlier expected, although the all-important German numbers remain in progress.

French milk intake was down 1.7% in June, continuing a long run of year-on-year declines, helped by hot-dry weather, but milk is gradually coming closer to the 2016 comparatives given the rapid contraction that was underway last year. **Ireland** lifted June deliveries more than 6% after growing strongly through peak milk in May which was more than 7% up. **Poland** had a strong month as well, above the same period in 2016 by close to 7%, but June 2016 collections dipped 2%.



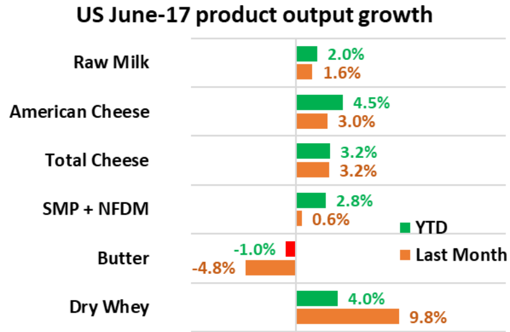
The UK stabilised in June, up 1.3% over June 2016, but was in steep decline this time last year, falling by more than 7%, which lasted six months as lower commodity prices flowed directly through to farmers. By our assessment, these latest numbers will likely offset the expected decline in **Germany's** milk deliveries and falls in Dutch and Danish deliveries, combining to leave June output at about 1% higher than June 2016.

Teagasc: Rising incomes, more risk management – Irish agriculture and food development authority Teagasc's Situation and Outlook forecast predicts average dairy farm incomes to rise to between €75,000 and €80,000 in 2017, and while the income boost is sorely needed, farmers also need to focus on the challenges that lie ahead, according to Irish Farmers' Association (IFA)'s National Dairy Chairman Sean O'Leary. He said farmers needed greater access to risk management tools, such as fixed milk price contracts and other forms of hedging in order to manage their variable incomes. Furthermore, rapid expansion on some farms has shown a major labour shortage with Teagasc estimating an additional dairy operatives and managers will be needed on farms by 2020, an issue to be addressed through a combination of national promotion and training programmes.

COOL debate – The European divide on country of origin labeling (COOL) on food has flared up again after EU ministers met to discuss COOL measures in July as Belgium, Germany, the Netherlands, Luxembourg and the Czech Republic had become concerned about a French pilot project for mandatory labeling on milk and foodstuffs containing milk or meat, which came into force in January. Belgium claims its dairy and meat exports to France has fallen by 17% since June 2016 compared to the same period in 2015. France defended the pilot project which it said was about improving consumer information. Eight EU countries have decided to introduce mandatory labeling for dairy and other products, including France, Italy, Lithuania, Portugal, Romania, Greece, Finland and Spain.

US dairy market and policy

Cheese output sustained in June – US dairy output data released by USDA last week showed **cheese output** lifted 3.2% in June and took the first half total up 2.7%. Cheddar production rose 3%, while Italian varieties were 3% stronger, while some of the minor lines posted declines. American cheese demand (mostly cheddar) was close to 3% higher in H1-2017, but for other varieties (dominated by mozzarella) was flat with slow foodservice trade.



Adjusted for the 2016 leap year

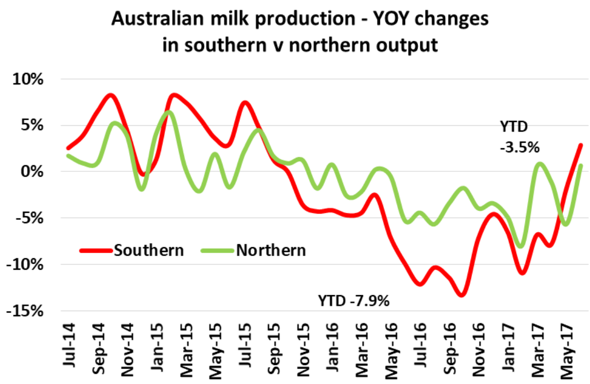
NFDM output surged almost 12% in June, while the output of smaller categories of SMP and WMP each fell 28% in the month. The **net change in low-fat milk powder** was as a result slightly higher than the comparative and 2.8% higher in H1-2017 over the same period in 2016. Dry whey output also surged, just as the China market started to slow!

Butter production was down 4.8% for the month (and down more than 10% in western region plants), suggesting a larger volume of fat went into cream products….or that USDA numbers (for either NFDM or butter) aren't correct. The shrinkage in butter output possibly helped the CME firm at the end of the week, rising above US$6,000/t to leave the week's closing price at its highest since December 2015.

Oceania dairy markets

Westland raises payout – Due to cost cutting of around NZ$70m over the last ten months, Westland Milk has lifted its forecast milk payout range to NZ$6.40kgMS – NZ$6.80kgMS for the 2017/18 season following two years of weak payouts. According to chief executive Toni Brendish Westland's focus on improving efficiencies in the organisation has enabled the board to forecast a more competitive payout for the coming season.

Debt slug ahead – The latest AgFirst financial survey for Waikato-Bay of Plenty dairy farmers shows that farmers' debt will be a challenging issue until 2020. Survey compiler Phil Journeaux said the model farm used in the budget incurred an additional NZ$1kgMS of term debt in 2015/16 to cover the low milk price that year. 80% of suppliers took up loans that had to be repaid once the payout exceeded NZ$6kgMS. Journeaux said that the impact of compulsory loan repayments and heavy capital expenditure to meet compliance demands weighed heavily on farm budgets for this and will continue to do so next season.



Australia's milk down 7% last season – Australia's milk production ended the 2016/17 season with a small revival as milk production lifted 2.2% in June, which saw national output down 6.9% for the season.

Milk production in the key southern regions lifted 2.9% in June compared to last year. The only surprise was that the southern increase wasn't stronger, given the sharp 9% fall in June 2016 in response to the drastic milk price step-downs by MG and Fonterra. This can be put down to the weak sentiment in Northern Victoria, where June 2017 milk output was on a par with that in 2016, but the region produced 1.746bn litres in 2016/17, down a thumping 16.5% on the prior season. Over the full season June milk production for the southern manufacturing regions slid 7.9% on the prior year.

Other news

Chinese investment in Canadian formula plant - A Chinese-owned infant formula plant being constructed in Ontario will source its milk dairy ingredients from Canadian producers. Feihe International's $225-million 300,000-square-foot facility, is scheduled to open in 2019, and plans to process about 60,000 tonnes of dry product each year, of which about 85 per cent will be shipped back to China.

The investor has done plenty of work to get the most out of the Canadian system – when operational, the plant will utilize Canadian milk priced under the Class 7 pricing system. Feihe is registered in the Cayman Islands. Its new Canadian subsidiary is incorporated as Canada Royal Milk, created so it can access the same government funding available to domestic processors. Feihe has been approved for two federal programs: the milk access for growth program, and a matching investment fund, which pays non-repayable contributions to companies that innovate.

LOL hit by hedging – Land O'Lakes has reported growth in revenues for the first half of the year, but net earnigns dropped due to unrealized hedging costs. Sales rose 2.8% to US$7.3bn in the six months to the end of June, while net income fell 6.3% to US$223m. The hedging loss came in at US$4m, compared to an unrealized hedging gain of US$26m in the first half of 2016. Earnings from operations, excluding impact of hedging costs climbed 8% to US$262m. Strong showings in the crop inputs sector and animal nutrition segment were offset by lower performance in dairy and investments in its Land O'Lakes sustain unit, which focuses on environmental sustainability.

Arla pushes "Pure Dairy"– Arla Food Ingredients has launched a new campaign called "Pure Dairy" to highlight how its range of Nutrilac dairy ingredients satisfies growing consumer demand for natural products by being produced from whey proteins extracted from milk, produced by grass-fed cows, hormone free, non GMO and free of antibiotic and pesticide traces. According to Arla's Senior Category Manager for Fresh Dairy Products Torben Jensen, Arla's Pure Dairy campaign highlights that its products address consumer concerns about additives.

Lion's profit slips – In its Q2 results for 2017, Japanese parent Kirin Group has reported lower sales and earnings from its Australian Dairy & Drinks division. Despite particularly strong sales in its specialty cheese and yogurt categories, the division was adversely affected by a shortage of oranges, causing dairy and drinks division sales to fall 1.1% compared to Q2 2016 to $923m, while operating income for the unit fell 6.5% YOY to $29m in Q2 2017. Kirin expects the LD&D division in the full financial year to achieve sales in line with the prior year, but to lift earnings 13% to $82m.

Lala will buy Vigor – Mexico's Grupo Lala has confirmed it is in talks with investors in Brazilian dairy Vigor to buy the Brazilian dairy. Vigor's largest investor is J&F Investimentos, which is the Batista family company that controls Brazil's largest meat processor JBS. Lala said the deal was subject to approval by its board and its shareholders and would not disclose the financial terms of the deal. It has previously been rumoured that PepsiCo has made two bids for Vigor.

Mataura on track – According to Mataura Valley Milk manager Bernhard May, Southland farmers are showing interest in becoming shareholders and the company is on track to fill its milk supplier requirements. May is confident Mataura will contract the 25 – 30 suppliers needed by December. The company will manufacture infant milk formula from its nutrition plant at McNab with production expected to begin in August next year and a full capacity of 30,000t of infant formula. Mataura Valley Milk is a partnership between New Zealand and overseas investors.

Beingmate loss worsens, will sell farms – Fonterra's Chinese investment partner Beingmate has forecast a NZ$70m loss for the first half of the year and has announced it is selling dairy farm assets to improve earnings. A spokesperson for Fonterra said Beingmate was operating in a highly fragmented and uncertain infant formula market and reiterated that Fonterra's NZ$700m investment in the Chinese company gave access to the Chinese infant formula market and an extensive distribution and sales network. Beingmate had originally forecast a profit, however, its shares fell 10% and were suspended after charges were laid against the company for insider trading.

Dean Foods shares drop – After reporting second-quarter numbers that missed analysts forecasts and issuing a profit warning Dean Foods saw its shares drop 11.49% in pre-market trading earlier this week. Dean Foods posted higher second-quarter and first-half net sales but the growth it saw on its top line during the quarter was below Wall Street estimates. Profits fell over both periods and Q2 earnings per share was lower than analyst estimates. Net income stood at US$18m, compared to US$33m a year prior, while operating income reached US$45m, down from US$73m. Net sales rose 4.2% to US$1.93bn, adding to a 5.2% increase in first half net sales of US$3.92bn. CEO Ralph Scozzafava said the company had faced a challenging and rapidly evolving retail environment, impacted its total volume performance within the quarter.