INTRODUCTION

The profitability of UK dairying has turned around in the last 12 months. Milk prices have recovered strongly since their low-point in the summer of 2016. In addition, inflation in input costs has not been as high as was feared. The better returns may well last through into 2018, but price volatility is now a feature of the UK dairy market. Brexit continues to cast a shadow over the whole farming sector. Producers need to use current profits wisely to set themselves up for an uncertain future.

PRICES

The upswing in milk markets that began in summer 2016 continued through the winter. This was driven by reduced output in the major dairy exporting regions coupled with robust demand (especially for butterfats). Over the summer of 2017 the market has been rather directionless, illustrating that supply and demand are currently in reasonable balance.

In fact, global milk prices have stabilised at levels well below the peaks seen in recent market cycles (e.g. 2013). UK prices have been boosted by the continued weakness of Sterling. In simplistic terms, Sterling at €1 = 92p adds 7ppl to milk prices compared to a rate of €1 = 70p. The £/€ exchange rate is also helping the UK beef sector which supports dairy cull and calf prices.

A weak Sterling would usually mean higher input costs (especially for imported inputs). However, large global harvests have kept a lid on grain prices and competition in the fertiliser market has limited increases. Whilst the low oil price has constrained energy costs, electricity and diesels prices have risen. Many inputs are more reliant on the Dollar exchange rate than the Euro, and the recent weakening of the Dollar is helping keep costs low.

Looking ahead, production is edging-up around the world. With global prices steady-but-not-spectacular, it is hoped that any increases in production will be modest. Prices may be nearing their peak for this cycle of the dairy market. Although 2018 may see some weakening of values, it is hoped that this is gentle rather than another slump.

Volatile commodity prices for milk are now a fact of life. The UK industry is now (belatedly) recognising this and innovative contracts, offering longer-term pricing are now starting to appear.

POLICY

The end of the 2018/19 milk year coincides with the formal date of Brexit. At the time of writing, the negotiations do not appear to be proceeding particularly smoothly and the final outcome remains clouded in uncertainty. Some sort of 'transition period' seems likely, but the form and duration of even this is unknown.

The UK's eventual future trading relationship with the EU will have a huge influence on our dairy industry. An arrangement that preserves current trade flows would be the least disruptive to markets. If no deal can be done, then tariffs would severely impede trade (in both directions). It should be remembered that the UK is a net importer of dairy products, so there might be opportunities for import substitution. Prices *might* even rise in a protected domestic market. But the UK processing sector would have to be re-orientated to adapt to these new demands. Over time, any boost to prices from restricting EU products would likely be eroded as the UK does trade deals with the likes of Canada, the US, Australia, New Zealand and South American countries.

Until we formally leave the EU, the Basic Payment Scheme will continue to operate. Thus there will be at least one more BPS in 2018. And our view is that the current scheme will be retained (with some tweaks) through to 2020 whilst a new policy is put in place. Again, the nature of this future support is uncertain. The Government has guaranteed funding at current levels through to the end of this Parliament (2022), but it seems likely that support will be paid in a very different way in the future.

PROFITABILITY

The table shows the latest profitability figures from Andersons Friesian Farm model. It is a 150 cow business in the Midlands with a non-aligned contract. The 2015/16 year saw the full effect of the collapse in dairy markets with a very low milk price. The first shoots of the recovery, and some cost savings saw the situation improve somewhat for 2016/17. However, Friesian Farm was still in the position of needing the Basic Payment to get it into profit.

FRIESIAN FARM ppl	**15/16** Result	**16/17** Result	**17/18** Budget	**18/19** F'cast
Milk Price	22.7	23.2	27.9	27.1
Output	25.3	25.8	30.7	29.9
Variable Costs	12.0	11.5	11.9	12.0
Overhead Costs	9.8	9.6	9.9	10.1
Rent, Fin. & Draw.	4.7	5.0	5.1	5.0
Cost of Production	26.5	26.1	26.9	27.2
Farming Margin	(1.2)	(0.3)	3.8	2.7
BPS/SPS and ELS	1.6	1.8	1.8	1.8
Business Margin	**0.4**	**1.5**	**5.6**	**4.5**

Farmgate prices climbed through the first half of the current, 2017/18, year and assuming markets remain robust, the average milk price for the year should be close to 28ppl. As already noted, input price rises have, so far, been relatively muted. This helps deliver a budgeted return of 3.8ppl from milk production on this farm. Add in the Basic Payment, and the profit is back to levels seen before the dairy crisis.

Long-term forecasts are fraught with danger, but the prospects for 2018/19 currently look reasonable. The milk price might weaken as output starts to nudge up. There is also likely to be some cost inflation still to work through the system. This reduces profitability a little, but it remains at sustainable levels

PERFORMANCE

Friesian Farm provides an insight into the returns for an 'average' dairy business. There is a strong argument that simply operating at today's average levels will not be good enough in the future.

All dairy farms need to challenge themselves to be open to new ideas and ways of doing things, and to be willing to learn from the top performers. Recent information from AHDB highlights the potential benefits from block-calving systems. Much of the industry has drifted into year-round (and high-cost) production systems without stepping back and evaluating all the options. The whole supply chain needs to be better at working together to reap the efficiencies that undoubtedly exist.

Even without radical change, good management is vital to optimise the returns from existing systems. A series of seemingly minor improvements can soon add up to a significant increase in efficiency.

Producers should continue to strive for the lowest cost of production even with better prices. Markets will turn again at some point and a low COP means they will remain profitable at a wider range of milk prices (and make more money whilst prices are good). Every element of spending should be challenged to ensure that it is productive, worthwhile and genuinely contributes to farm profitability. Joint ventures have an important role to play in helping the sector restructure itself for improved performance.

HELPING YOUR BUSINESS

Dairy businesses need to use the current period of better profits to prepare for the future. For some, making investments for the long-term will make sense. For others, simply paying down debts and making the business more robust will be worthwhile.

Andersons already work with some of the most progressive dairy businesses. Our consultants can help you make the correct strategic decisions and improve profitability.

Through its regional businesses, Andersons are leaders in independent business consultancy in UK agriculture. Please contact one of the offices below for more details on the topics covered in this publication.

Melton Mowbray
The Andersons Centre
Tel: 01664 503 200

Brecon
The Andersons Centre
Tel: 01874 625 856

www.theandersonscentre.co.uk

York
Andersons Northern
Tel: 01347 837 100

Edinburgh
Andersons Northern
Tel: 01968 678 465

www.andersonsnorthern.co.uk

Salisbury
Andersons Midlands
Tel: 01722 782 800

Leicester
Andersons Midlands
Tel: 01664 821 930

Hereford
Andersons Midlands
Tel: 01544 327 746

www.andersonsmidlands.co.uk

Bury St Edmunds
Andersons Eastern
Tel: 01284 787 830

www.andersonseastern.co.uk

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