Will downturn experience be of help in the future?

Experience gained from managing through recent industry downturns should benefit New Zealand dairy farmers if they choose to set up their businesses to be "one step ahead of the price curve", according to a new industry report.

In its recently-released report, *Oceania Dairy - Let's Debt Serious*, agricultural banking specialist Rabobank says the New Zealand dairy sector is particularly exposed to market volatility and dairy farmers need to strengthen their business structures by rebuilding equity in the next price upcycle and further developing flexible production systems that can easily reduce costs when milk prices fall.

Report co-author and dairy analyst Emma Higgins said the current severe price downturn marks the third trough in the past decade and the sector must plan for inevitable future volatility.

"Tough decisions will need to be made in the next upward cycle. Farmers will need to make a careful and considered decision whether to put some debt to bed or chase a profit margin through increased investment and spending," she said.

"Ultimately, New Zealand dairy farmers need to be the most cost-competitive among their global peers in order to be one step ahead of the price curve - in both good times and bad. The experience they have accumulated in recent downturns should help them do just that."

The report says New Zealand's dairy industry has a greater need to build resilience compared with other milk-producing countries, due to its significant exposure to global markets and the resulting price volatility.

"With a minimal ability to sell milk into more stable and often higher returning local markets compared with other exporting nations, the New Zealand industry is largely at the mercy of global market influences and therefore subject to greater exposure to volatility," said Ms Higgins.

"Because the majority of dairy product produced in New Zealand is exported, both positive and negative shocks affecting the global dairy industry are felt more keenly here."

Ms Higgins says the mix of dairy products exported — with whole milk and skimmed milk powder making up 59% of NZ dairy exports - also increased the potential price volatility for New Zealand.

"Bulk milk powder will always be the more volatile commodity of the dairy complex, due to its ability to be stored and its basic processing nature," she said.

The report also notes that while there is ongoing push from New Zealand processors to grow and invest in value-add business, there are limits to how much milk can be shifted to higher value streams.

"The simple reality is that, when faced with a wall of milk in the height of the season flush, the options for processing the sheer volume of milk are limited to producing large volumes of powder-based commodities destined for export to the world market," said Ms Higgins.

"There is nothing wrong with being a low cost commodity player, as long as the whole industry is prepared for continued volatility and dairy farmers have resilient business structures."

New Zealand dairy debt

With New Zealand dairy debt having steadily increased from NZ$11 billion in 2003 to a current record high of NZ$39 billion, the report says the industry now accounts for 68% of total New Zealand agricultural debt.

"The upward debt trend reflects the expansion of the industry, when improving dairy returns fuelled an improved appetite for land acquisition," Higgins said. "The expansion can also be partially attributed to New Zealand policy changes introduced in 2010 to provide sufficient liquidity buffers which stimulated credit flows, along with a sustained appetite for lending from some banks."

According to the report, the "average New Zealand dairy farmer" entered the current prolonged downturn highly geared and the average debt per kg/MS remains near record levels at NZ$20/kgMS. As a comparison, the report says the equivalent Australian (Victoria) dairy farm debt is 65% lower, at around NZ$7/kgMS.

"Debt is a useful tool for generating an effective return on equity along with an opportunity for increasing business growth. Conversely, too much debt can be damaging to the farm business, with little resilience to withstand adverse events," Ms Higgins said.

While until recently returns had been improving on average since 2007/08 — including a record milk cheque in the 2013/14 season — the reports says the "average New Zealand farmer" had opted not to take the opportunity to repay debt in good seasons.

"For some vulnerable farmers there may be a need to strengthen the balance sheet through alternative sources of equity for future downturns," she said.

While there is not much upside for prices in the 2016/17 season, Rabobank's just-released Dairy Quarterly forecasts prices to rise modestly in the first-half of 2017.

"We are finally starting to see the taps of global supply turn off, as farmers around the world adjust production in the face of continued lower prices," said Ms Higgins. "We all know that current low prices are not sustainable, and this supply response together with stable demand growth in the US and Europe are expected to see exportable surpluses dramatically reduce."

Cost competitiveness essential

The report says increased use and rising prices for key inputs, such as feed, combined with increased levels of debt servicing, pushed up the average production cost between 2011 and 2013.

"While milk prices rose around 22% in the period from the financial crisis to the record milk cheque in the 2013/14 season, major expenses, such as supplementary feed and grazing costs, increased by 43% over the same period," Higgins added.

"New Zealand dairy farmers can take some comfort in the fact they have been able to quickly refocus budgets and pare back costs in response to the price slide. By going back to basics and focusing on pasture growth along with maximising home grown feed, expenses for feed have come back from the 2013/14 peaks by around 20%, assisting all five New Zealand dairy production systems."

With dairy farmers facing the likelihood of a third consecutive season with a low farm gate milk price, it was imperative that a focus on cost management is maintained.

"The challenge will be to keep cost control in mind when the cycle turns and milk prices improve." MG