WAIRERE
Romneys & Composites

May 2008

Client Newsletter

What does the future hold?

The Bad News.

The DROUGHT has been so widespread across the country that most store and finishing farmers have taken a beating. Land use change to dairying and dairy support has added to the supply of surplus stock, and reduced the demand for store stock. Wairarapa farm consultants calculate 60-70% of the reduction in income for 2007-8 for their clients is drought related rather than market related. Many dairy farmers throughout New Zealand will end up with incomes similar to the previous year, despite a 64% increase in the price of milksolids.

This is shaping to be the worst financial year for sheepfarmers since the 1930's depression. In addition to poor returns and widespread drought there is a lot of debt in the sheep and beef sector now. The Meat and Wool Economic Service's calculation of EBIT (earnings before interest and tax) is only part of the story. Interest bills are helping to create accumulated cash losses.

The Good News.

The supply/demand equation looks great for next season.

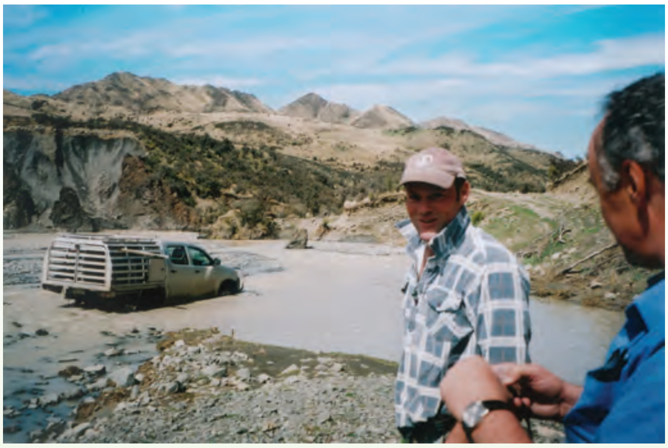
Export tonnage of lamb will be down more than ten percent for 2007-08, by my calculation. Average carcase weight is running a kilogram below normal, which would result in a 24,000t deficit; and the predicted shortfall of 1.5m lambs will reduce export tonnage by another 26,000t.

The lamb crop in 2008 will be substantially lower again, due to a smaller ewe flock, a drought affected lambing percentage, reduced inputs, and fewer hogget lambs. The combined effect could reduce the number of lambs for export by three to four million, or fifty to seventy thousand tonnes, 12 to 17% of historical norm.

Beef export predictions are 20 -25% reduction on recent history, for 2008/9.

Carbon Footprint

UK retailer Marks and Spencers has introduced packaging with aeroplanes printed on it, to warn customers that the food has been airfrighted. Sales of those products have increased, because consumers know how fresh they are!



Hamish McRae, Lochiel Station, north Canterbury, with PGG/Wrightson stud stock agent Graham Sidey. "Don't let Derek Daniell tell you that crossing a river is on."

The $100 Lamb.

To quote Keith Woodford Agribusiness Professor of Lincoln University. "Many of the price rises for commodities have yet to flow through into the foods we eat. Whereas a year ago the grain cost component of a kilo of chicken was 80 cents, it's going to be $2 – to which everyone in the supply chain will add their mark-ups".

One hundred dollars for a 17kg lamb is $5.88 net per kg. How realistic is this target as a seasonal average? The supply/demand economics (big kill down of pigs, cattle, sheep) suggest a world shortage of meat in the near future. All meats will be repositioned at a higher price level.

Aussie saying.

"A win win for supermarkets is screwing the farmers twice".

The Megamerger debate.

It has recently been announced that the megamerger concept has been abandoned. The concept had a simplistic appeal, so I will go through the agruments for and against.

The proponents of a megamerger suggest a number of potential benefits.

- Better negotiating power. In 1980 English lamb producers received 66% of retail price, today they receive 44%.

- British dairy farmers used to have a monopoly selling their product, the Milk Marketing Board. That was disbanded in 1995. Since then the British farmer return for a litre of milk has plunged from 58% of the average retail price to 37%.
- Supermarket profits have risen astronomically from 3% margin on milk in 1995, to 31% margin in 2006, yet farmers have been selling at a loss.
- However, it is inaccurate for megamerger supporters to parallel the UK liquid milk industry with NZ lamb – a monopoly selling NZ lamb would not be tolerated.
- There are potential savings on the home front. Rationalisation of processing plants, transport and administration would take out a lot of cost.
- Greater profitability should allow a bigger spend on marketing, research and product development.
- NZ farmers would own 80 -85% of processing and marketing.
- Fragmented industries do not make good profits.
- In general only industries with consolidation will be profitable for their members. These organisations are able to invest for the future because they can afford research and development, investment in their value chain, and a level of quality management and directors unsupportable for low profit firms in fragmented industries.

Good profits every year?

Have you heard of an agricultural product which delivers farmers a high margin all the time? Think potatoes, apples, wheat, kiwifruit, pine trees, squash, pig meat, cheese, onions, venison, velvet, olive oil, wine. Any profitable crop attracts more and more supply until it tips into oversupply.

The downsides of a Megamerger

- How do you react when a supplier suggests a significant price increase? You consider competitors and substitutes. No buyer likes monopolies or strong sellers. There would be intensive political lobbying to remove New Zealand's control of the sheepmeat quota. This is the only EC quota controlled outside Europe. Buyers would demand better access to Australian and South American product.
- What is going to stop supermarkets from colluding? They get caught occasionally. Evening Standard, December 7th 2007: "The Office of Fair Trading has handed out fines totalling £116m after supermarkets including Sainsburys and Asda admitted they were part of a milk fixing cartel that took over £270m extra from British shoppers".
- Farmer shareholders would have to foot the bill for the closure of eight processing plants.
- There is a price to pay for plant rationalisation. To the end of February 2008, processors killed 1.5m more sheep than the year before. Given rationalisation those animals would still be sitting on farms. Farmers would need to farm at more conservative stocking rates to cope with a planned unload of lambs and cull ewes to the works.
- The supposition is that a number of small companies always take the price down. This is not true. In 2004 -05, the price of racks was lifted from U.S. $5.50 per pound to $10.00. This seemed to work well short term, but the 82% price rise resulted in a halving of demand in the United States, our major market for racks. Four years later, there is still an overhang of racks in freezers
- A big company would get fat and lazy, and would try to beat up on the small players. If Fonterra is so good, why do a number of companies in Australia offer similar returns? As does the main co-operative in Uruguay.
- Negotiating with British supermarkets involves a small percentage of NZ lamb. Scarcity of supply will be the main lever to a significant lift in wholesale price. Scarcity will contribute to a shift of perception of NZ lamb from commodity to luxury item.
- The reality is that Australian lamb sets the price in markets outside the E.U.
- The other reality is that competitors and substitutes are easier to find with meat compared to dairy

Ewes and lambs on top of the Jeff farm. October 2007 produce. You can choose beef, lamb, pork, chicken, fish, venison.

- The proposed legislated moratorium on new entrants would be of huge benefit to existing players. It would enable them to close plants and rationalise at least cost and spread the financial burden over more investors. For any existing player wanting an exit strategy, this would be a golden parachute.
- Alliance did not invite North Island shareholders a few years ago. Now that Alliance will have to rationalise plants, they want North Island farmers to share the costs.
- New entrants have usually spearheaded change, be it greater efficiency in processing or niche marketing. A big player can become cost heavy and slow to move. Witness the competition to Fonterra now that the three year moratorium has been lifted. A megamerger with 85% of the business would be lucky to retain that proportion longterm.

Conclusion

PPCS is right to seek comprehensive analysis of the megamerger proposal. Where is the business plan, and detailed explanation of benefits?

On the plus side sheepfarmers would not like to see all of processing/marketing owned by non-farmer interests. But no one has explained why 80 – 85% of sheepfarmers might invest capital in a merger, and the other 15 – 20% stay outside the consortium but enjoy the possible benefits. What about those farmers who have invested in small companies outside the proposed megamerger?

The supply and demand balance is key. Despite PPCS having 65% of NZ venison supply, the price of venison was in a trough for four years, until the oversupply worked through the system.

Perhaps there is another way to rationalise. Tim Miles, the new CEO of Wrightson, relates how Vodafone and Orange, the two biggest players in the UK mobile phone market, got together to explore ways to improve profitability in a cluttered market. They combined cell sites, and closed down 30per cent. That reduced costs for both companies, gave better coverage, and enabled them to deliver better value to customers. But the companies remained independent.

We farmers know that a lift in product prices has a strong leverage on land values, our primary source of wealth. We wait with interest to see whether the megamerger plan is rehatched. Currently, many North Island farmers would not invest.

Getting through the winter

For drought stricken farmers the current warm autumn is as unreal as a phoney war. Around the corner is Winter and pregnant animals, with their uncompromising response to gross underfeeding. Light destocking and prayer, combined with an obliging Winter climate will **not be enough**. Any feed budget done shows this clearly.

Ken and Sharon McRae, South Otago. A record 161% lambing, October 2007

The dreaded N word deserves better consideration than it sometimes gets. New Zealand farmers ladle on phosphate and sulphur to produce nitrogen indirectly. But in droughts, the clover factory does not work. Nitrogen is the cheapest supplement available, apart from grazing off (sometimes). This is the autumn to boost capital stock in preparation for better prices next season. For many of us that will mean extending the overdraft, but the strategy will be well rewarded. In many situations, the alternative is capital stock in poor condition and slow lamb growth to weaning.

The store market for lambs next season will depend on late spring rainfall, in the North Island. If there is good grass growth, there are many under stocked properties which will consider store lambs a good option for a short term trade. It is likely that fewer Friesian bull calves will be reared next spring. All cattle will be expensive.

In the South Island, there has been a bigger shift out of sheep/beef finishing into dairying or dairy support. A move to greater self sufficiency in finishing lambs at home may be necessary to protect gross income.

What is happening in Australia?

This past year many of the Australian lamb crop have had access to grazing cash crops too poor for harvesting. This coming year, a doubling or better in grain prices has prompted a record planting of cash crops, and the lamb industry may miss out on what has traditionally been a cheap source of feed for feedlotting. Sheep numbers continue to fall, because of drought and low prices.

In low rainfall areas, compaction by sheep means that 275mm is required to grow a cash crop, compared to 200mm without sheep. So some farmers are going right out of sheep.

Australia is a grouping of regional economies. Tasmania has about the same GDP per head as New Zealand, New South Wales and Victoria are about 40% ahead, and Western Australia and Northern Territory are close to 80% ahead. This differential shows up in wage rates. It is hard to keep farm workers over there from drifting to the mines, and it will continue to be difficult to keep Kiwis in New Zealand.

Pierre is back

Pierre has returned from Australia for three months with Wairere, before completing a final five months with a West Australian rambreeding venture. He will be mainly in the South Island, where Hamish Woodhouse has had to forgo Wairere in favour of his dairyfarming involvement.

Pierre has some observations of the NZ sheep industry from his perspective in W.A.

- High cost systems do not work over time. Survival in WA is based around low cost. Need to re-address the basis on which New Zealand pastoral farming has been successful in the past, that is low cost efficiency.
- NZ is losing staff to Australia because of better pay and conditions.
- Have to reduce work load that is involved with sheep farming, i.e. mainly around wool, especially belly and crutch (example of the technology gain that has been achieved in the air conditioned GPS tractor versus still chipping dags off sheep in woolsheds.

David Smith, North Otago. A spray/burn development out of tussock. The climate has been tough going for a couple of years, but the new grass paddocks respond well. David's hoggets had a great lambing in 2007.

Higher costs beyond the farm gate

The FOB returns for lamb in New Zealand dollars have been remarkably similar over the past six years, 2002 – 03 to 2007- 08 at $NZ2.3 bn. Sure, numbers of lambs exported have changed to some extent, but it demonstrates that New Zealand costs beyond the farm gate have risen sharply. Shortage of people to run existing processing technology is becoming a major issue. Let's hope that new robotic technology can eliminate the need for so many people, and make jobs in processing more attractive.

On farm costs

The soaring cost of fertiliser, and energy, look set to change the settled relativity of the past decade. The outcome will probably be lower stocking rates, reduced performance, and farmers being more self sufficient in finishing their own stock. Longer term, options will include lower inputs and a search for alternatives to our clover based feed supply.

What type of sheep required for the future?

It would be tempting to take a punt on carbon credits, and plant the whole farm in trees. However, what is created out of thin air by regulation can also be taken away.

Under a lower input system, sheep will need to be hardier, but have high growth rate. The ideal lambing percentage may be lower under a low input system.My jury is still out on eliminating wool. There are a few sheep around which offer that possibility, but it is a small genepool. There is the opportunity for a halfway house with some breeds like the Texel and East Friesian offering crosses which require minimal dagging/crutching.

We will continue to experiment in the search for the ideal sheep. In the meantime, selection of our Romney sires for hardiness under high stocking rate pressure and minimal drenching is being helped by droughts and hard winters. Many times we hear farmers express amazement at how well the Wairere sheep bounce back after a hard time.

Last laugh:

Investment havens in a time of panic.

Read in The Economist, March 22nd 2008. "If the world is going to hell in a handbasket, what should you buy?............ In his book "Wealth, war and Wisdom", Barton Biggs, a Wall Street veteran, suggests that investors should own, as insurance against the apocalypse "a farm or a ranch somewhere far off the beaten track but which you can get to quickly and easily"

A sheep farm in New Zealand would not really qualify, unless you already live in Wellington……….."

We know how tough it has been for you. But the worst is over. We look forward to a great year ahead.

Warm Regards Derek *and the Wairere Team*

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