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Poised for Growth Investment Opportunities in Australian Dairy

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The Australian dairy industry is poised to grow again and play a more significant role in the global market. Confidence amongst progressive dairy farmers is rising, seasonal outlook is improving, and export competitiveness is higher as the Australian dollar continues to fall. This article provides a guide for Investors who want to review opportunities now unfolding ‘Downunder’, as the Australian dairy sector rebuilds its competitive advantage in the decade ahead.

Both Asian and local demand growth is driving Australian dairy

Agricultural Investors know the story of Asia’s fast growing imports of dairy products and the key role that both New Zealand and Australia are playing in supplying these markets. Dairy is one of Australia’s big farm export earners, with Strategis Partners projecting the value of exports to exceed U.S.\$3 billion by 2015.

The significance of Asia’s dairy consumption growth cannot be overstated. Chart 1 illustrates how Asia’s projected imports (in milk equivalent volumes) are likely to expand far beyond total current milk production in Australia and New Zealand.

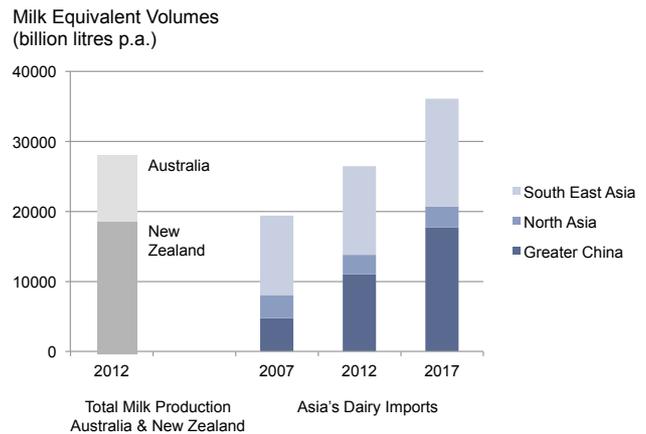
South East Asia’s dairy consumption is expected to increase by 3 billion litres p.a. by 2020, while local supply in those countries will not keep pace with consumption growth, according to Rabobank¹.

Investors may not be aware of the fact that Australia’s dairy consumption continues to grow in volume and value, accounting for about half of all milk production. Australia’s 23 million people enjoy a high standard of living, with average annual incomes approaching U.S.\$60,000 per person. Per capita dairy consumption is now more than 300 liters p.a. in milk equivalents.

¹ Source: Rabobank International, *ASEAN-6 Dairy Markets*, Rabobank Industry Note #385, July 2013.

CHART 1

Asia’s dairy imports set to outstrip total ANZ milk supply



Source: Strategis Partners’ projections, Dairy Australia 2007 and 2012 statistics.

From the perspective of Strategis Partners, the Australian dairy industry offers four strategic themes for Investors, based on the comparative advantages of four selected dairy regions:

continued on page 2

Inside:

Executive Profile: Rory Richards6
Global Ag Opinions8

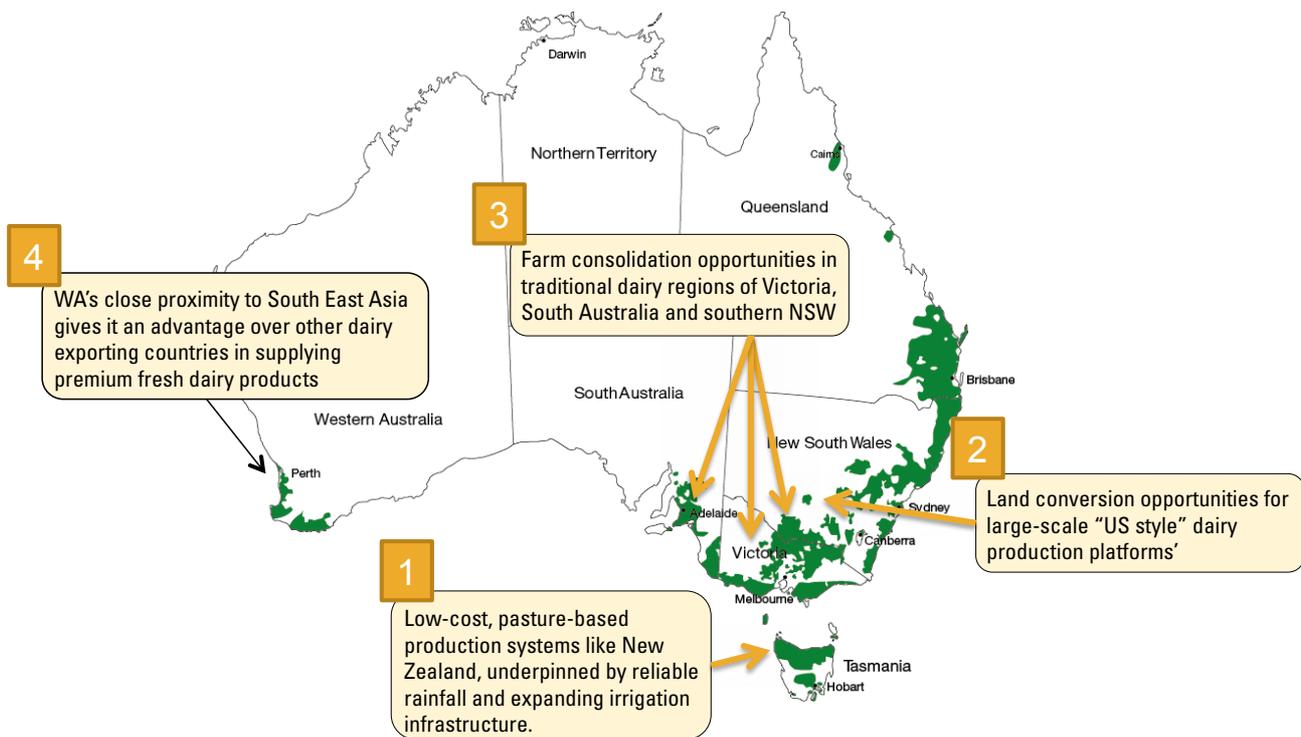
Deals of the Quarter: A Summary of New Fund Formation, Allocations, Transactions, M&A Activity and Joint Venture 10

Poised for Growth Investment Opportunities in Australian Dairy

continued from 1

CHART 2

Four dairy regions and their comparative investment opportunities



Source: Strategis Partners analysis; map courtesy of Dairy Australia. The areas shown in green are the dairy producing regions of Australia.

1. Expand in Tasmania – the ‘new New Zealand’
2. Build large-scale “U.S. style” dairy production platforms in south-west New South Wales through cropping and livestock land conversion
3. Go for consolidation in traditional dairy regions of Victoria, South Australia and southern NSW
4. Establish a position in Western Australia’s fresh dairy future and the State’s growing connection with South East Asia.

The map of Australia in Chart 2 above shows these four regions and their comparative investment opportunities.

In each of these regions, there are opportunities for investors to form joint ventures with progressive dairy farmers to build operations with scale, produce value-added dairy products and exploit new technologies and systems.

Table 1 (page 3) explains the key market and production drivers and the types of investments in each of these four investment themes.

1. Expand in Tasmania – the ‘new New Zealand’

Tasmania is becoming an innovative dairy exporter – similar to what New Zealand did 30 years ago – with an emphasis on producing premium dairy products such as speciality cheeses. Like Kiwi dairy farmers, Tasmanian dairy farmers benefit from a low-cost, pasture-based production system, underpinned by a temperate marine climate, reliable rainfall and expanding irrigation infrastructure.

New Zealand’s dairy industry is facing stronger headwinds, with production flattening out in the next decade, according to a recent Rabobank report². This is now opening up opportunities for Tasmania.

continued on page 3

² Source: Rabobank, NZ Dairy – From a torrent to a trickle, Rabobank Global Focus newsletter, August 2012. NZ’s limits to growth are multifold: regulatory measures to address the environmental impact of milk production; rising costs, complexities and greater exposure to volatility with larger-scale production systems; less available land conversion opportunities; and higher technical barriers to entry for new start-ups.

Poised for Growth Investment Opportunities in Australian Dairy

continued from 2

TABLE 1

Multiple ways to invest in the Australian Dairy Industry

| Investment theme | Key drivers | Types of Investments |
|--|---|---|
| 1. Expand in Tasmania – the 'new New Zealand' | <ul style="list-style-type: none"> • Growing Asian demand for powder and cheese • Plenty of land for profitable expansion of low-cost milk production through conversion of cropping & grazing farms • New irrigation schemes support low cost, pasture-based dairy systems • Tasmanian dairy is generating high returns • New Zealand's dairy industry is facing limits to growth over the next decade | <ul style="list-style-type: none"> • In established dairy areas, scale up farms based around low production cost model through pasture-based farming –aim for optimal farm size of 1,000 cows • In developing dairy areas, convert cropping and grazing farms to dairy farms – aim for optimal farm size of 1,000 cows • Innovate with automation technology on-farm • Expand powder and cheese production capacity • Establish partnerships with Asian food & dairy companies |
| 2. Build large-scale "U.S. style" dairy production platforms in south-west New South Wales through cropping and livestock land conversion | <ul style="list-style-type: none"> • Growing Asian demand for stored dairy products • Secure access to water, in remote areas, supports establishment of large-scale dairy operations • Diversify farm income streams by introducing dairy into traditional cropping and sheep farms | <ul style="list-style-type: none"> • In remote areas convert parts of cropping farms, with access to secure water supply • Implement new large scale "U.S. style" dairy production systems via new farms with 10,000 cows or more • Expand over time into an integrated farm and processing enterprise • Invest in water rights in the Murray-Darling Basin • Establish partnerships with Asian food & dairy companies to supply export markets |
| 3. Go for consolidation in traditional dairy regions of Victoria, South Australia and southern NSW | <ul style="list-style-type: none"> • Growing Asian demand for premium dairy products • Lower unit costs of existing manufacturing plants by increasing throughput • In many areas dairy farming is the most financially attractive farming enterprise | <ul style="list-style-type: none"> • In established dairy areas, scale up by merging existing farms – aim for optimal farm size of 1,000 cows • Convert cropping and grazing farms to dairy farms – aim for optimal farm size of 1,000 cows • Establish a network of large dairy farms • Establish partnerships with Asian food & dairy companies to expand powder & cheese production |
| 4. Establish a position in Western Australia's fresh dairy future and its growing connection with S.E. Asia | <ul style="list-style-type: none"> • Growing demand for fresh dairy products in WA and S.E. Asia will outstrip local supply in the coming decade • "Horizon 1" market: strong domestic growth in WA • "Horizon 2" market: S.E. Asian markets of Singapore, Malaysia, Hong Kong • "Horizon 3" markets: Indonesia, India and The Philippines • Converting cropping & grazing farms to dairy could increase value of new operations | <ul style="list-style-type: none"> • Capture supply chain efficiencies by establishing an integrated dairy business including on-farm production, processing & export • Invest in farmland and convert from cropping and grazing farms to dairy • Scale up existing on-farm production in south-west W.A. – aim for optimal farm size of 1,000 cows • Establish new farms with large scale (10,000 cows plus) "U.S. style" dairy production systems with feed supplied by WA's large wheat industry • Build value-added processing plant, form J.V. or acquire existing processor • Supply chain infrastructure for fresh produce into S.E. Asia • Establish partnerships with S.E. Asian food & dairy companies |

Poised for Growth Investment Opportunities in Australian Dairy

continued from 3

The returns to capital invested in Tasmanian dairy farms are amongst the best in Australia and New Zealand. When capital appreciation is included, returns from Tasmanian dairy farms over the last decade have average 9.7% p.a., and in 2010-11 the top farms achieved a return on assets of 15%³.

With these levels of profitability, Tasmania's milk output is poised to double to 1.5 billion litres per year over the next decade. For investors considering investing in Tasmania, there are multiple opportunities including large-scale pasture-based milk production, speciality cheese manufacture and large-scale dairy commodity processing.

As a general guide, the initial investment for a farm, based on optimal size of 1,000 cows, is around \$10 million. There is an opportunity for further investment by establishing a network of dairy farms and by investing downstream in processing.

2. Build low-cost, large-scale dairy production platforms in south-west NSW

In the southwest of New South Wales, large-scale dairy operations can be established by converting farmland from cropping and sheep. These could be based on new "U.S. style" dairy production systems with 10,000 cows or more, via Joint Ventures between existing farm owners and long-term investors or American dairy operators. This conversion model suits very large cropping operations with access to secure water supply.

As a general guide, the initial investment would range between \$50 to \$100 million for farm assets, increasing to \$250 million over five years to fund herd expansion, on-farm dairy processing and manure-to-methane energy supply.

3. Go for consolidation in traditional dairy regions

In the traditional dairy areas of Victoria and southern New South Wales (Gippsland, Murray Valley and Western Victoria), and South Australia the opportunities are: (1) to scale up by merging existing farms in order to achieve more cost-efficient herd sizes of 1,000 cows, up from current average herd sizes of 250 to 300 cows⁴; (2) convert cropping and grazing farms to efficient-size dairy farms; and (3) establish a network of large dairy farms and integrate downstream into processing.

These regions are at the centre of Australia's mainland dairy processing industry, providing opportunities to establish partnerships with Asian food & dairy companies to expand powder & cheese production. Local Governments actively support investment such as dairy processing plants. For example, the Wodonga City Council plans to establish an agribusiness precinct as part of its strategically located 'Logic' distribution, transport and manufacturing centre⁵.

In the past year, major dairy manufacturers including Devondale (the

Murray Goulburn Co-operative Co. Limited), Fonterra, Bega Cheese, Warrnambool Cheese & Butter (WCB) have made commitments to invest over U.S.\$300 million in new factories and upgraded plant and equipment.

In late 2012, leading U.S. yogurt manufacturer Chobani opened its \$30-million manufacturing facility in Melbourne's south-east, with a capacity to produce 30,000 tonnes of yogurt p.a. The plant serves as an export hub to drive further growth of the Chobani and Gippsland Dairy brands into Asia.

4. Establish a position in fresh dairy in Western Australia

The WA dairy industry gives investors an opportunity to benefit from consumption growth in fresh milk, yogurt and dairy spreads in the WA and South East Asian markets.

Historically, Australasian dairy exports to Asia have comprised primarily milk powders, butter and cheeses. However a 2012 Strategis Partners' Study⁶ suggested that WA could become an innovative dairy exporter – with an emphasis on "fresh" exports.

WA dairy has two sustainable competitive advantages: (1) its proximity to Singapore, Jakarta and Kuala Lumpur which are located within just four to six days sailing from the port of Fremantle at Perth; and (2) its potential to expand its dairy farming in the south west of WA.

To realize this fresh dairy export opportunity, new supply chain investments can improve overall project economics. For example, logistics solutions such as 'MilkyWays' designed by Dutch engineering firm, Trilobes, point the way to cost-effective, aseptic containerized transport of bulk liquid milk⁷.

A key investment opportunity in WA is to establish an integrated dairy business. One strategy is to acquire existing farms, develop new dairy farms and secure access to processing plants. As a general guide, the initial investment required to establish an integrated business would be approximately \$125 million, increasing to around \$300 million over five years.

Conclusion: Developing a sound investment strategy

In summary, these four regional examples demonstrate the wide range of investment opportunities for participating in the growth of the Australian dairy industry. To optimise the long-term value from such investments, there are three key issues for Investors to consider in developing a sound investment strategy:

1. Scale of investment drives returns on capital

The following table shows is the case of Tasmanian dairy farms how the projected return on total capital invested (farm operating profits excluding capital gains on land) will increase with scale.

continued on page 5

³ The website, <http://www.intodairy.com.au> contains financial and other relevant information on the Tasmanian Dairy Industry.

⁴ For a discussion of herd size trend, see Dairy Australia Report, Situation and Outlook May 2013, p. 59.

⁵ For more information on Wodonga's Logic manufacturing, transport and logistics precinct, visit <http://www.wodonga.vic.gov.au/business-investment/logic/what-is-logic.asp>.

⁶ This Report, prepared for Wesfarmers Limited, examines the strategic options to build a sustainable dairy industry in Western Australia. Download a copy at www.strategispartners.com.au/report-on-wa-dairy-industry

⁷ For more information on Trilobes, visit their website: <http://www.trilobes.com>.

Poised for Growth Investment Opportunities in Australian Dairy

continued from 3

TABLE 2

Returns from dairy farms in Tasmania increase with scale ⁸

| | | | |
|----------------------------|-------|-------|--------|
| Cows milked | 250 | 750 | 1,000 |
| Capital (\$000's) | 3,230 | 9,210 | 12,100 |
| EBIT (\$000's) | 132 | 546 | 821 |
| Return on Capital Invested | 4.1% | 5.9% | 6.8% |

2. Investment in large scale "U.S. style" production systems

These large-scale operations primarily represent an investment in infrastructure and dairy cows, whereas farmland associated with the operations represent only a small portion of the total investment. Therefore, while the ROC tends to be higher than investing in a traditional dairy farm, the investment does not have the same upside exposure to capital gains from appreciation in the value of the agricultural land.

3. Investment in processing

The economics for investing in dairy processing need to be clearly understood prior to making any investments. For example, to be competitive in manufacturing commodity milk powders for the Chinese

⁸ Source: Tasmanian Government Report, The Dairy Industry in Tasmania – A Guide for Investors, 2012. www.investtasmania.com.au.

market a plant would need to have a minimum capacity of 1.5 million litres p.a. in order to compete with existing plants in Victoria and New Zealand. If, however, a plant is part of an integrated dairy farming and processing model producing high quality value added dairy products, the minimum economic scale would be substantially smaller.

In conclusion, there are compelling reasons for making investments positioned to capitalize on the next phase of growth in the Australian dairy industry. Australia's and Asia's growth in dairy consumption will underpin the need for expanded production. Expansion opportunities exist in developing dairy regions such as Tasmania and the Great Southern region of Western Australia to meet this growing demand.

As the result of the recent fall in land prices for dairy farms in some regions, acquiring dairy farms in Australia has become attractive compared to other countries while at the same time the sustained fall in the Australian dollar during 2013 is making dairy exports once again competitive. ■

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