



Company strategy and performance report

March 2011

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Introduction.

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This report aims to provide milk producers with insight into the strategy and performance of Britain's major milk buyers.

The business strategy and market position of any milk buyer is likely to have a significant impact on current and future returns to each of its suppliers. For most of the companies covered in this report the milk they buy from farmers is their biggest single cost, and therefore how successful they are will have a major impact on the amount of milk they purchase and the milk price they can pay their producers.

Increased understanding and knowledge of the milk buyer's business operations and place in the market will help producers make better long term decisions about how and where they sell their milk, and where, how and even whether they farm.

In particular, and from a milk producer's viewpoint, the report looks at:

- What is the potential of my milk buyer in terms of security of demand and its ability to pay a competitive milk price?
- What is the long term strategy of my milk buyer and how can I best structure my dairy enterprise to fit in with that strategy?
- How is the milk buyer performing as a business and in the market place and how does this affect my long term options?

The report provides detailed analysis of the eight largest milk buyers in Britain, examining their milk procurement, contracts and milk pricing, markets and financial situation. It does not cover every issue faced by the market or individual companies, but does identify concerns, allow comparison and increased understanding.

The remainder of the report is divided into two main sections. The first section summarises the main findings in the report, looking at the main features of how the companies do business. Included in this summary is how milk is procured, how contracts are structured, the milk prices offered, market performance and headline financial performance.

Following this section, there is a series of company profile reports, which look at each of these areas in more depth for the individual companies in turn. The analysis is based on the 2009/10 milk year, although significant events which have occurred since the year end are discussed. Each of these company reports will also be available as a standalone report. Our forward plan is to update these company profile reports annually, on a rolling basis. A ninth company report will be published in March on Glanbia Cheese Limited, although its results have not been included in the summary report.

Overview of findings.

When assessing the strength and potential of a prospective milk buyer, it is important to understand the way the company does business, including how its contracts are structured, the milk price it offers, how it performs in the markets in which it operates, and its financial position. Each of these topics is covered below. A more detailed review is available in the individual company reports.

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Milk procurement.

D. The dairy industry has undergone a great deal of concentration over the past 15 years as a result of market forces. There has been a reduction in the number of milk buyers, which have grown in size and, in many cases, become more specialised.

Those buyers who are able to grow are those which are able to successfully compete in their markets and gain business. This is partly determined by having a product which is in demand and partly by how competitively they can supply the product. It is worth understanding your buyer's share of the market, which other buyers are of a comparable size, and the average producer size for each buyer to provide a picture of their competitive position and their current and potential future demand for milk. Within the company sections of the report, there is also information supplied on each buyer's main competitors.

Milk Purchases (2009/10 milk year)

	Producer numbers	Average producer size (m litres)	Total milk purchases (m litres)	% purchased by source		% of direct supply on retailer-aligned contracts
				Direct contracts	Third party purchases	
Arla	1,400	1.2	1,900	89%	11%	57%
The Caledonian Cheese Company*	186	1.5	335	82%	18%	-
Dairy Crest	1,400	1.1	2,185	72%	28%	24%
First Milk	2,500	0.7	1,730	100%	-	3%
Meadow Foods	525	1.1	580	74%	26%	-
Milk Link	2,000	0.6	1,440	86%	14%	-
Müller**	150	1.4	240	90%	10%	-
Robert Wiseman Dairies	950	1.1	1,770	60%	40%	78%

* Milk purchased for use by The Caledonian Cheese Company is now procured through Fresh Milk Limited. ** DairyCo estimate

Looking at the milk procurement of the major milk buyers and how this has changed in recent years, there are three key trends: average farm size is getting larger, more milk is being procured through direct supply contracts, and a larger proportion of milk is aligned to dedicated retailer contracts. Each of these trends is discussed below.

There has been a shift towards larger farms on direct supply contracts, with the average producer size over the major buyers increasing from 0.87m litres to 0.91m litres over the last year, mirroring industry trends. With the exception of First Milk and Milk Link, the average producer size on direct contracts is over one million litres per annum. The buyers with the largest milk suppliers on average are Müller and The Caledonian Cheese Company,

both of which have specialised production and restricted catchment areas. Caledonian Cheese has a policy of encouraging expansion from its direct suppliers (see company profile report), meaning it is likely to see further increases in average supplier size.

Larger farms are also likely to be more attractive to buyers as it reduces costs associated with the collection and testing of milk. The buyers with the smallest average farm size are the cooperatives, which will be affected by the geographical distribution of their suppliers.

With the continued decline in producer numbers in the dairy industry, most milk buyers are moving towards increasing the proportion of milk supplied from directly contracted producers. This will have the effect of reducing their demand for milk from third party suppliers such as the cooperatives or independent brokers. This is generally being done in order to reduce the buyers' risk in securing milk supplies. While the move to increase direct supply volumes creates opportunities for some farmers to sign up to a direct supply contract, it also poses a risk to farmers supplying milk to buyers who are involved in brokering, as they will be facing a shrinking market.

The third trend which has affected the procurement of milk is the increase in retailer aligned contracts. These have developed over the past few years, as major retailers have sought to secure their supplies, in response to the downward trend in GB milk production. Aligned contracts are primarily limited to the three large liquid milk processors; Arla, Dairy Crest and Robert Wiseman Dairies, who together supply the majority of retailer own-label milk. Approximately 20% of the milk produced in GB during the 2009/10 milk year was purchased on dedicated retailer aligned contracts¹, a similar proportion to the previous year. This is likely to increase during 2011, as the Co-operative aims to introduce a dedicated supply contract from August 2011, although the number of farmers and volumes of milk it will cover are not yet known.

Contracts

While there are a great deal of contracts available, all with slightly different terms and conditions, the majority of milk buyers are looking to recruit larger farms with flat production profiles and prefer to recruit farms which are in their current collection areas. Location and farm size will therefore have an impact on which contracts are available to an individual farmer.

All major milk buyers will want producers to be farm assured, although the standards and schemes requested are likely to differ according to client requirements. For example, M&S or Waitrose may request that farmers on its dedicated supply contract comply with additional farm assurance requirements than other retailers. The table below summarises key features of the contracts for each buyer. A more detailed picture of the different contacts available for each buyer is included in the company profile reports.

¹ While Morrisons pay a bonus on its milk purchases from Arla, the bonus is paid to all farmers on the AFMP contract and not just to a dedicated group of farmers aligned to supplying milk for Morrisons, and therefore these volumes are not included in the calculation.

Milk Supply Contracts (2009/10 milk year)

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Company	Notice period (producer)	How are price reviews triggered	Geographic limits for new recruits	Additional benefits
Arla	12 months	Company performance and market conditions 6-monthly cost tracker for Tesco contract	Focus on South of England	Technical advice, negotiated discounts on inputs
The Caledonian Cheese Company ²	3 months	Market conditions and returns, position relative to competitors	SW Scotland & Cumbria (Stranraer factory)	Interest free loans, expansion bonus
Dairy Crest	12 months	Company performance, market conditions and returns	M&S – Cornwall Davidstow - Cornwall & Devon	Technical advice, group buying
First Milk	12 months (exit dates at end of Mar, Sep and Dec) or 6-month buyout option in Mar, Sep	Market returns in end market 6-monthly cost tracker for Tesco contract	Tesco contract - Wales	Technical advice, group buying
Meadow Foods	12 months (quarterly exit points)	Market returns	NW England, North Wales & Derbyshire	n/a
Milk Link	12 months	Market returns and co-operative performance	Contracts are regionally based	Technical advice
Müller	12 months (suppliers since 2008)	Market returns and input costs	30 mile radius of Market Drayton	Unknown
Robert Wiseman	3 months (cannot give notice in July or August)	Market returns, position relative to competitors 6-monthly cost tracker for Tesco contract	Actively recruiting in SW England	n/a

It is interesting to note the wide variation on the notice periods that milk producers are required to give to leave contracts, from 3 months to potentially 18 months. The shortest notice period of 3 months is offered by The Fresh Milk Company (Caledonian Cheese)² and Robert Wisemans Dairies, although the latter has a caveat that notice cannot be given at the end of July or August. First Milk's contracts have a 12 month notice period, but only offer exit points at the end of March, September or December. There is an option for producers to buy out 6 months of this at the end of March and September. However, a producer

² These contracts are now held and managed by Fresh Milk Limited, although the majority of the purchased milk is used by The Caledonian Cheese Company Limited.

giving notice at the beginning of April will effectively be under notice for 18 months.

Another key point to recognise is that none of the current contracts, with the exception of Milk Link's Cumbrian Direct contract, have a transparent mechanism for determining the price paid to farmers for their milk. While all of the companies examined in this report state that a minimum of one month's notice is given for a price drop, the contracts do not stipulate what triggers a price adjustment. The short notice period for price changes by the buyers does not allow for producers to easily move their milk to alternative buyers, putting farmers at a disadvantage when making business decisions.

In addition, few contracts at producer level specify which market indicators are used when setting the price. Most have a base price that can be moved up or down as determined by the milk buyer, who can use different market signals to justify the changes. In many cases, price changes are stated to be linked to market returns and/or market conditions, at other times they may be based on milk supply, and in some cases buyers state that prices are adjusted to ensure they remain in line with competitors.

Milk prices

During 2010, powder, butter, cheese and cream wholesale prices remained at high levels throughout the year, yet the expected increases in milk prices paid to producers did not materialise. In the period from April 2010 to December 2010, the average prices for the four main commodities were higher than the 2009/10 average, which should have improved market returns to dairy processors.

The table overleaf summarises the product markets the main buyers are involved in and the average prices paid, according to the DairyCo standard litre, for the 2009/10 milk year. It also indicates the total of the price changes which have taken place between April 2010 and February 2011³. It can be seen that for the 2009/10 milk year, the price paid on liquid milk contracts were generally higher than that paid on cheese or manufacturing contracts and companies who sell into added-value markets.

³ Although there have been some announcements made of price increases effective March 2011, these have not been included as it may be that there are further announcements.

Milk prices paid (average 2009/10) and adjustments year-to-date

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	DairyCo Standard Litre 2009/10 average price (weighted across all contracts)	Total price changes* (Apr-10 - Feb-11)
Arla		
Liquid	24.82	+0.50
The Caledonian Cheese Company		
Cheese	23.55	+2.00
Dairy Crest		
Liquid	24.75	+0.42
Cheese	23.99	+2.25
First Milk		
Liquid	21.62	+2.20
Manufacturing	21.17	+2.05
Cheese	22.44	+3.15
Meadow Foods		
	23.22	+1.00
Milk Link		
Liquid	23.50	+2.53
Manufacturing	22.92	+2.75
Llandyrnog (cheese)	22.84	+1.50
Cumbrian Direct (cheese)	24.04	+1.605
Robert Wiseman		
Liquid	26.14	+0.40

Note: annual average prices are weighted averages of monthly milk prices where data on volumes by contract are available and simply averages otherwise.. Data is unavailable for Müller.

*Price changes set by retailers on dedicated supply contracts are not included; for example the 0.6ppl Winter feed supplement paid by Sainsbury's or the 6-monthly price changes paid on Tesco contracts.

During the year, milk for cheese contracts saw more price increases than liquid milk contracts, and as a result, moved up the DairyCo league table. While prices paid on liquid milk contracts aligned to major retailers remain at the top of the price league table, the cheese contracts have in many cases overtaken non-aligned liquid contracts with price adjustments between April 2010 and February 2011, ranging from 1.08ppl to 3.15ppl. Prices paid for milk on manufacturing contracts have also responded to the continued strength of the commodity markets.

Prices paid on liquid contracts have not seen as many increases over this period, with the larger dairies of Arla, Dairy Crest and Robert Wiseman Dairies only implementing one price increase each between April 2010 and February 2011. While the co-operatives appear to have adjusted prices paid on contracts for liquid milk more in line with market movements, the milk is primarily being used for the production of milk for the long-life milk market or being sold to third parties for balancing or food manufacture.

A portion of the milk sold to third parties by the larger co-operatives is sold on long-term contracts, so the degree to which prices they pay can respond will depend on

the length of these contracts, how sales prices are agreed and the volumes committed. The key to maximising returns from third party sales, and passing these on to the milk producers, will be to manage the balance between secure sales through contracts and the sales which are able to capitalise on movements in commodity markets.

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Markets.

D. The market a milk buyer operates in will impact on its profitability and growth potential, and therefore on the milk price it can pay. There is a hierarchy of markets, with certain segments of the market providing better or more stable returns.

Distribution of raw milk to market sectors (2009/10)

	dedicated liquid milk supply	non-aligned liquid milk market	brokering in liquid milk market	branded dairy products	non-branded and commodity cheese market	other dairy products (i.e. cream, butter)	other commodity processing (i.e. whey, SMP)
Arla	51%	13%		13%		23%	
The Caledonian Cheese Company				56%	29%		15%
Dairy Crest	17%	53%		21%	6%	3%	
First Milk	3%		57%		28%		12%
Meadow Foods			50%			50%	
Milk Link		8%	32%	10%	38%		12%
Müller				100%			
RWD	46%	39%		15%			

At the top of this hierarchy are the dedicated liquid milk supply chains where premiums are paid to ensure stable volumes. Branded and premium product markets also offer a good degree of market stability and higher margins. As dairy products become less specialised or differentiated however, margins tend to become tighter, and markets less stable as the number of competitors increase and the focus becomes one of low cost rather than high quality.

Historically, the most stable market segment for milk was for retailer own-label milk, especially for those who operated dedicated or differentiated supply chains. These contracts generally provide the best returns to dairy farmers, and offer a secure market which creates opportunities for investments and growth. However, market conditions in the liquid market during the past 12 months have become increasingly competitive. The majority of the retail market is supplied by 3 large dairies, and the competition between them to maintain or grow sales volumes has impacted on wholesale selling prices. If the reduced operating margins are sustained this is likely to limit the potential for farmgate price increases.

A similar situation exists in the market for branded Cheddar, where discounting has become prevalent over the past two year. A number of milk buyers appear to have similar strategies for their Cheddar brands. Most are aiming to grow market share or become

one of the leading brands in the market and are discounting sales prices at the expense of profit margins to achieve this. As these deals become more common place it becomes increasingly difficult to pass on increasing operating costs to retail or wholesale buyers.

An area where there may be a lack of involvement by companies is within dairy commodities. With the possible exception of Meadow Foods none of the companies really focus on dairy commodity production. Indeed some milk buyers have taken an active strategy of reducing their exposure to commodity markets. The co-operatives Milk Link and First Milk have flexibility to shift milk into commodities from other areas of their business but have not done this in a significant way as they are mindful of damaging relationships with long term customers. This strategy will have potentially restricted returns in the short term. However, it is important to acknowledge that while a conservative approach to commodities limits the upside when markets are rising, it should also limit the downside when markets fall.

In addition to determining which sector of the market a buyer operates in it is also important to look at whether these markets are in growth or decline. A profitable market this year, if declining, does not necessarily offer a secure market in the future and buyers must ensure they are adapting to changes in the market. How the main market segments are performing in terms of volume and value is discussed in the individual company reports.

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Financial overview.

D. An assessment of the accounts of a company provides a view of its ability to generate returns as well as its financial security. Financial information must, however, be assessed in conjunction with information on its products, markets and strategies to obtain an overall picture of its performance and potential. Details on how the ratios and figures outlines in this report have been calculated can be found within Annex 1.

Some of the key financial figures have been summarised below for ease of comparison, followed by a discussion on the relevance of various indicators. When comparing results it is important to distinguish those companies with external shareholders from the co-operatives, which are owned by their supplying members. The latter exist to return value to their members, and do so through a combination of milk price and returns on member investments (which are distributed in various forms). This is important as the co-operatives may decide to pay members a high milk price during the year instead of making a large operating profit.

During the 2009/10 financial year, Milk Link paid an 8.1% return on member loans, which equated to an additional payment of 0.35ppl for milk supplied in the year. First Milk did not pay a dividend to members during the year, although a payment of 3% on member investment was made in January 2011.

Headline financial figures of the eight buyers⁴

	Year end	Operating profit*		Profit before tax		Equity/member reserves	
		£m	ppl	£m	ppl	£m	ppl
Arla	31/12/2009	168.9	1.95	143.6	1.66	1006.1	11.62
The Caledonian Cheese Company**	31/12/2009	5.9	1.78	2.9	0.87	42.4	12.77
Dairy Crest	31/03/2010	96.6	4.42	73.8	3.38	292.8	13.40
First Milk	31/03/2010	-0.4	-0.02	-0.3	-0.02	45.6	2.64
Meadow Foods	31/03/2010	5.7	0.98	5.5	0.95	13.0	2.24
Milk Link	03/04/2010	19.6	1.36	10.6	0.74	59.4	4.13
Müller⁴	31/03/2010	37.2	15.50	36.9	15.38	43.9	18.29
RWD	03/04/2010	50.3	2.84	49.2	2.78	139.6	7.89

* Operating profits are net of any exceptional items and do not include pension costs.

** The Caledonian Cheese Company is a limited company which is owned by Lactalis McLelland UK Limited, and is involved solely in the production of cheese. The financial analysis has been done on the group accounts of Lactalis McLelland UK. See the company report for further details on the structure of the companies.

⁴ Pence per litre figures were obtained by dividing financial figures by the total volumes handled. For Arla they refer to the whole group as they do not produce separate accounts for its UK business. For Dairy Crest, the ppl figures have been obtained by dividing the financial figures which apply to the whole DC business (including its Fresh and Irish subsidiaries) by UK milk volumes and will therefore be inflated. Müller's profit figures are inflated as no debt is held on the UK balance sheet and its equity figures are high as there was no dividend paid to the parent company in the financial year, with total profits retained which more than doubled total equity.

Operating profit was calculated as the profit after costs of sales, including overhead and administration costs, but not including exceptional items, and therefore reflects how efficiently the company runs its operations.

Profit before tax provides a measure of the overall return to the company, accounting for finance and investment activities and any exceptional items. The pre-tax profit figure was used as taxes paid can be impacted by factors not necessarily related to the operations and primary activities of the company, making comparisons more difficult.

Total equity, or member reserves for the co-operatives, measures the value of the company's interest in property, including shareholders' equity in a business. A business which is not processing milk is likely to have a lower total equity as it does not need processing capacity. Equally, a business that is processing would normally hold investments and equity in processing capacity, and these should be kept up-to-date to maintain or increase competitiveness within the industry.

Financial ratios for the eight buyers⁵

	Pre-tax profit margin (%)	Gearing (%)	Quick ratio	Return on capital employed (ROCE)(%)
Arla ⁵	2.6	48.6	0.8	8.7
The Caledonian Cheese Company*	1.7	34.3	0.5	9.1
Dairy Crest	4.8	56.7	0.6	14.2
First Milk	0.1	60.7	1.1	0.3
Meadow Foods	2.1	3.3	0.9	48.9
Milk Link	2.1	38.0	0.5	20.5
Müller ⁵	9.2	n/a	1.5 ⁵	84.8 ⁵
RWD	5.6	15.0	0.6	30.6

*The Caledonian Cheese Company is a limited company which is owned by Lactalis McLelland UK Limited, and is involved solely in the production of cheese. The financial analysis has been done on the group accounts of Lactalis McLelland UK. See the company report for further details on the structure of the companies.

The Pre-tax profit margin ratio measures profits before tax as a percentage of total turnover and gives an indication of the company's profitability. It provides an indication of how much margin the company has available for the purposes of paying taxes, interest and dividends, and also for investing back into the business.

Dairy Crest and Robert Wiseman Dairies generated good pre-tax profits in the 2009/10 financial year on a pence per litre basis, although these figures reflect the situation prior to the effects of competition in the retail market, and the renegotiation of large retail supply contracts. The impacts of competition for retail volumes will become more evident in the forthcoming accounts.

Gearing indicates how much debt or borrowing the business has against its total capital employed, and is calculated as long term debt as a percentage of total capital employed, including both long term debt and total equity. It should be examined in light of investments and profits, and a company at the beginning of a large investment project may show

⁵ Ratios for Arla are for the whole company Arla amba. Müller's ratios will be impacted due to the UK assets and debts being held on the accounts of the parent company and not the UK subsidiary.

a high gearing figure although they are investing in increasing their efficiency.

There are relatively high gearing figures for Arla and Dairy Crest, which can be attributed to ongoing investment projects. First Milk has the highest gearing of the companies investigated, although this is an improvement on the previous year, with their November 2010 trading update showing a further reduction in debt.

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The quick ratio measures the liquidity of the company, and compares short term assets to short term liabilities. This ratio should typically be 1:1, indicating that short term payment obligations can be met with liquid assets, not including inventories. A low quick ratio can be an indication of cash flow problems, while a high ratio may indicate that a company is not using its cash on hand effectively.

As the quick ratio does not include the value of inventories, under the assumption that items such as cheese stocks cannot necessarily be quickly liquidated to pay short term debts, it is often at a value less than one and within the dairy industry, averages around 0.85⁶. When examining the quick ratio, it must be considered whether the business holds stocks and how moveable they are – butter stocks are more liquid for example than cheese stocks which may not yet be mature or available for sale. This is demonstrated by the fact that The Caledonian Cheese Company⁷ and Milk Link have the two lowest quick ratios, are both heavily involved in the production of cheese, and will hold large cheese stocks.

Return on Capital Employed (ROCE) measures the performance of the company as a whole, or how effectively a company uses the money it has invested in its operations. It is calculated by dividing the operating profit by total capital employed. A low ROCE may be an indication that the business is not using its resources efficiently to generate profits. The majority of the companies examined in the report have ROCE figures within an acceptable range. Meadow Foods and Robert Wiseman Dairies show the highest ROCE, resulting from low debt levels and, in the case of Wiseman's Dairies, well-invested, modern facilities.

The ROCE for First Milk was negative for the 2009/10 financial year, impacted by reduced turnover. This was an improvement from the previous year, and according to figures published in its trading update, increases in turnover and reductions in debt should help to improve the ROCE figure in the next full financial year.

All of the major buyers reported a positive operating profit per litre with the exception of First Milk. However, the small loss reported in 2009/10 is an improvement on the previous year, resulting from improved alignment of milk prices to market returns and reduced debt resulting from the sale of a portion of its shares in Robert Wiseman Dairies.

⁶ Source: KeyNote Business Ratio Report, 2009.

⁷ Ratio refers to the financial results of Lactalis McLelland UK Limited

Company profile.

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Arla Foods UK is a subsidiary of Arla Foods amba, a Swedish and Danish farmer owned co-operative, with its head office based in Denmark. Arla Foods amba operates in over 100 countries and processes around 8.5 billion litres of milk annually, making it Europe's third largest dairy company. The UK is its largest individual market and accounted for 26% of revenues in the financial year ending 31 December 2009.

Arla stated its vision is to be the UK's number one dairy company by 2015. It aims to achieve this by ensuring it can source the raw materials required to meet current demand and future growth requirements, to improve performance in the own-label milk market through improvements in the functioning of the supply chain, to secure higher returns by introducing added-value products and by building new platforms for growth by entering new markets.

All direct suppliers of milk to Arla Foods UK are members of the Arla Foods Milk Partnership (AFMP), which owns a 3.2% stake in Arla Foods UK through a joint venture with Arla Foods amba. There are 1,400 farmer members in AFMP who, in the 2009/10 milk year, supplied 1,700m litres of milk to the company, accounting for almost 90% of the total milk demand.

The principal activities of the company are the supply of own-label and branded liquid milk and butter to the retail market, along with the production and marketing of dairy products such as cream, crème fraîche and more recently, cottage cheese.

The majority of Arla's liquid milk business is in the retail own-label market, where it accounts for around 45% of market volumes. Over the year, the company renegotiated its retailer supply contracts, losing volumes to its competitors in some cases, and securing long-term deals with other clients such as Asda and Morrisons.

Arla Foods announced that it plans to build a 1 billion litre dairy in Aylesbury which will be operational by the end of 2012. While there is no indication as to how this will impact on operations at its other dairies, the company has indicated that it may redistribute its raw milk supplies to ensure the best distributional fit.

Arla has recently purchased a stake in Westbury, allowing it to consolidate its own-label butter production to modern facilities. To ensure the best use of these facilities, it plans to move production from two European facilities and from the Settle dairy to Westbury.

Arla's main competitors in the liquid milk market are Robert Wiseman Dairies and Dairy Crest. Its flagship branded product 'Cravendale' is facing competition from retailer own-label filtered milk, as they move to capitalise on the growing popularity of the product. Arla holds a strong position in the market for butter, holding two of the most popular brands of 'Anchor' and 'Lurpak', but will face competition in the own-label butter market from other UK suppliers and imports.

Current position

- One of the largest milk buyers in the GB, representing 15% of milk production.
- Heavily dependent on three large retail customers, which accounted for almost 80% of its 2009/10 volume sales.
- Owns the 'Cravendale' brand, which is the leading brand in the growing market for filtered milk.
- Holds a large share of the retailer own-label milk market but facing strong competition from Dairy Crest and Wiseman Dairies.
- Supported by successful international farmer owned cooperative with a well-defined long-term strategy.
- Owns a number of well invested efficient dairies, with ambitious plans for future investment.
- With its focus on retail markets, Arla offer milk prices in the top part of the DairyCo league table.

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Future challenges and opportunities

- Will benefit from investment in Aylesbury dairy both in terms of efficient production facilities and potential increase in demand for milk.
- Will need to ensure it maintains retailer volumes to take advantage of efficiencies offered by the new dairy.
- Has grown the proportion of milk procured from direct supply by 10% over the past year, and may need to recruit more farmers to meet its growth forecasts.
- Aims to build "Arla" into a brand for dairy products within the UK retail sector, which could create the potential to add more value to the milk it processes.

Procurement analysis.

D. Milk purchases

The table below gives details of Arla's milk supply base for the 2009/10 milk year.

	Direct suppliers		Third party supplies		Total	Change from previous year
	Aligned	Non-aligned	Co-operatives	Other brokers		
Million litres	975	725	200		1,900	-2.5%
Numbers	840	560			1,400	no change

Milk deliveries from direct suppliers increased by around 6% from 1,600m litres in the previous milk year although the total amount of milk processed has remained relatively stable. This expansion in direct supply is primarily due to expansion from current suppliers as the number of suppliers has remained unchanged. These suppliers provide around 90% of Arla's milk purchases, up from 80% in the previous year impacting the volumes purchased from third parties, which fell by 50% over the milk year.

As a result of lower sales of milk and expanding supply volumes from producers, Asda reduced the size of its aligned milk pool by approximately 200 suppliers during the year. These suppliers were moved into the non-aligned pool, reducing the number of Arla Foods Milk Partnership (AFMP) members who remain in retailer aligned pools from 1,040 to 840.

Recruitment

With the increase in amount of milk supplied from AFMP members from 75% in 2007 to 90% in 2010, Arla is not currently looking for any further increases in direct supply. However, there is currently no restriction on expansion from current suppliers, but this will need to be balanced with market growth. Further recruitment of suppliers will therefore very much depend on Arla securing new volumes or on growth in current markets.

With the proposed development of the dairy at Aylesbury, Arla stated that while there may be a shift in where the milk of some suppliers is processed, but this will be done to ensure that transport logistics are maximised to reduce costs and should not affect individual farmers.

Any recruitment activity that does take place will be focused in the South of the country and ideally, Arla are looking for large farmers (1m litres +) with a flat profile although it would consider smaller suppliers in the right location (i.e. producers near Aylesbury will be more attractive once the new dairy is built). Arla uses balancing charges to encourage the required production profile, so those producers who are highly seasonal are more likely

to be affected by swings in commodity markets as payments on their excess production will be determined by what Arla can obtain on the open market for the milk.

Contracts

The table below summarises the main features of the supply pools operated by Arla.

	Contract 1	Contract 2	Contract 3	Contract 4
Name	AFMP	AFMP non-aligned	AFMP Asda	AFMP Tesco
Million litres	725		460	515
Producer numbers	560		350	490
End use	Liquid & manufacturing		Liquid	Liquid
Catchment area	National			
2009/10 average price (DairyCo standard litre)	23.62ppl	23.92ppl	24.65ppl	26.46ppl
Price changes Apr-10 to Feb-11	1 (+0.5ppl)	1 (+0.5ppl)	3 (+1.25ppl)	2 (+1.13ppl)
Reasons for price changes	“...continued weakness of dairy commodity markets and the consequential impact on all of Arla’s surplus cream returns.”*			Promar cost tracker

(Figures relate to the milk year 2009/10)

* Arla press release 07.04.2009 (<http://www.arlafoods.co.uk/media/arla-foods-confirms-reduction-in-milk-price-from-may/>).

Arla operated 4 different milk pools⁸ for their direct suppliers during the 2009/10 milk year, all of which supply liquid milk to retailers, with two being aligned pools. From October 2010, it also began to operate an aligned pool to supply 70 new Sainsbury’s stores with 20m litres of milk as part of their expansion plans. This represents approximately 5% of the supermarket’s liquid milk business. Nine AFMP members joined the Sainsbury’s Dairy Development Group (SDDG) and receive the Sainsbury’s premium.

Morrisons pays a premium of 0.30ppl for its milk supplied by Arla, although this is not paid to a dedicated group of suppliers. The bonus is shared amongst those in the AFMP non-aligned pool, and with the increased number of suppliers in this pool, due to the changes to the Asda milk pool, the bonus has been diluted to 0.25ppl.

Arla operates a balancing charge to deal with deliveries surplus to its requirements, based on an individual farm’s average daily production in October⁹, and calculates this monthly based on the returns it is able to obtain from the market. The setting of the baseline in October benefits those producers who are able to maximise deliveries at this time of year, as they will have higher autumn production figures to use as a base.

Volumes to dedicated pools fell in the 2009/10 milk year as competition for volumes in the retail market intensified. Although Arla retained the contract to supply 100% of Asda’s milk

⁸ Arla operate one standard contract, with variations in terms and conditions depending on the milk pool that producers supply.

⁹ As of late 2010, the base month changed from November to October for calculating the base average daily production.

requirements, Asda's sales volumes declined during the year as they lost market share to other major retailers and discounters (major multiples sales volumes declined by an average of 8.7% between the 2008/09 and 2009/10 milk year). In addition, Arla's share of the Tesco supply contract was decreased from 50% to 40% as of December 2010 as Dairy Crest gained a 5% share and Wiseman Dairies increased their share from 50% to 55%.

D. **Price review**

The AFMP farmgate price is set by Arla in conjunction with the AFMP board. Decisions on changes to the base AFMP price are proposed based on market conditions and company performance and are jointly approved. All direct suppliers are members of AFMP, and are represented by regionally elected producer directors who sit on the board along with equal representation by Arla directors. The markets are reviewed on an ongoing basis. Farmgate prices are reviewed when market returns and business performance indicate a need to change. The company is not contractually obliged to give notice of a price change, although it aims to give one month's notice of a price reduction.

Since the 2009/10 milk year, the AFMP price has been adjusted once (June 2010) following the recovery in commodity market returns. There have been no further adjustments since then despite commodity values remaining at high levels.

Asda suppliers have received three increases in this milk year of 0.25ppl in May 10 and 0.50ppl in both June 10 and October 10. The Tesco aligned price increased by a total of 1.13ppl through the year, including an exceptional adjustment made to account for increasing feed costs.

Exit policy

Arla Foods UK is required to give members 10 years notice to quit the contract. For producers to quit, they must give 12 months notice, which can be given at any time.

Farm assurance

Arla require that all AFMP members are assured through the Assured Dairy Farms (ADF) scheme.

Supplier benefits

AFMP operate a number of working groups to deal with technical issues, environment, milk balancing, communication and other relevant areas which aim to improve the business efficiency of farmer members. In addition, Arla has launched a 3 year initiative based on its environmental strategy which will provide workshops to help dairy farms to reduce their carbon footprint, and in turn, their costs.

D.

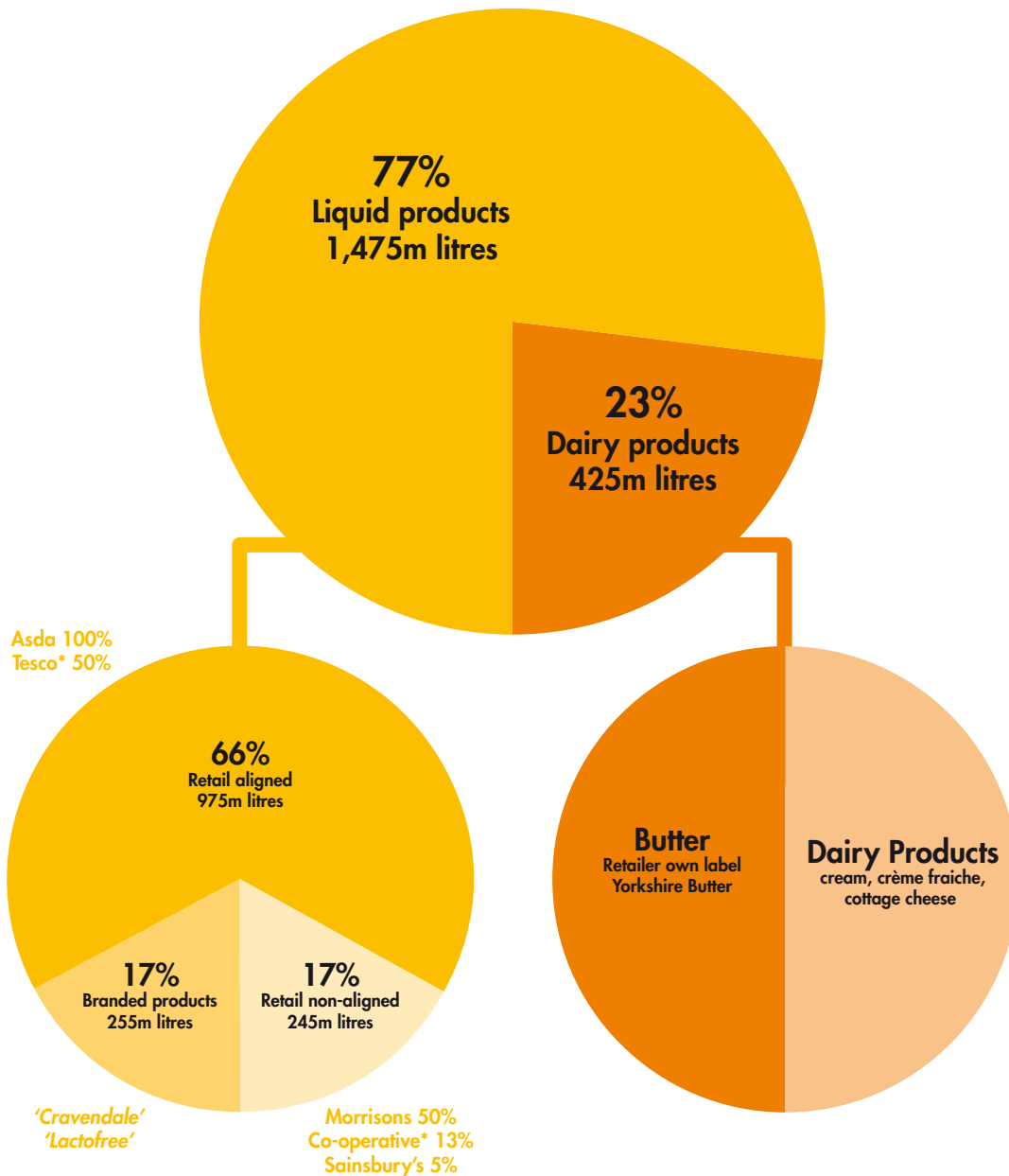
Highlights...

- Price increases for non-aligned suppliers have been static since June 2010.
- Structure of balancing charges benefit those farms which have late summer or early autumn calving patterns.
- Successfully renegotiated contracts to retain 100% of Asda milk supply until 2013 and 50% of Morrison's milk requirements until 2014.

Production analysis.

D. Product portfolio

Total milk purchases - 1,900m litres



Note: Retailer percentages refer to share of each retailer's milk supply requirements

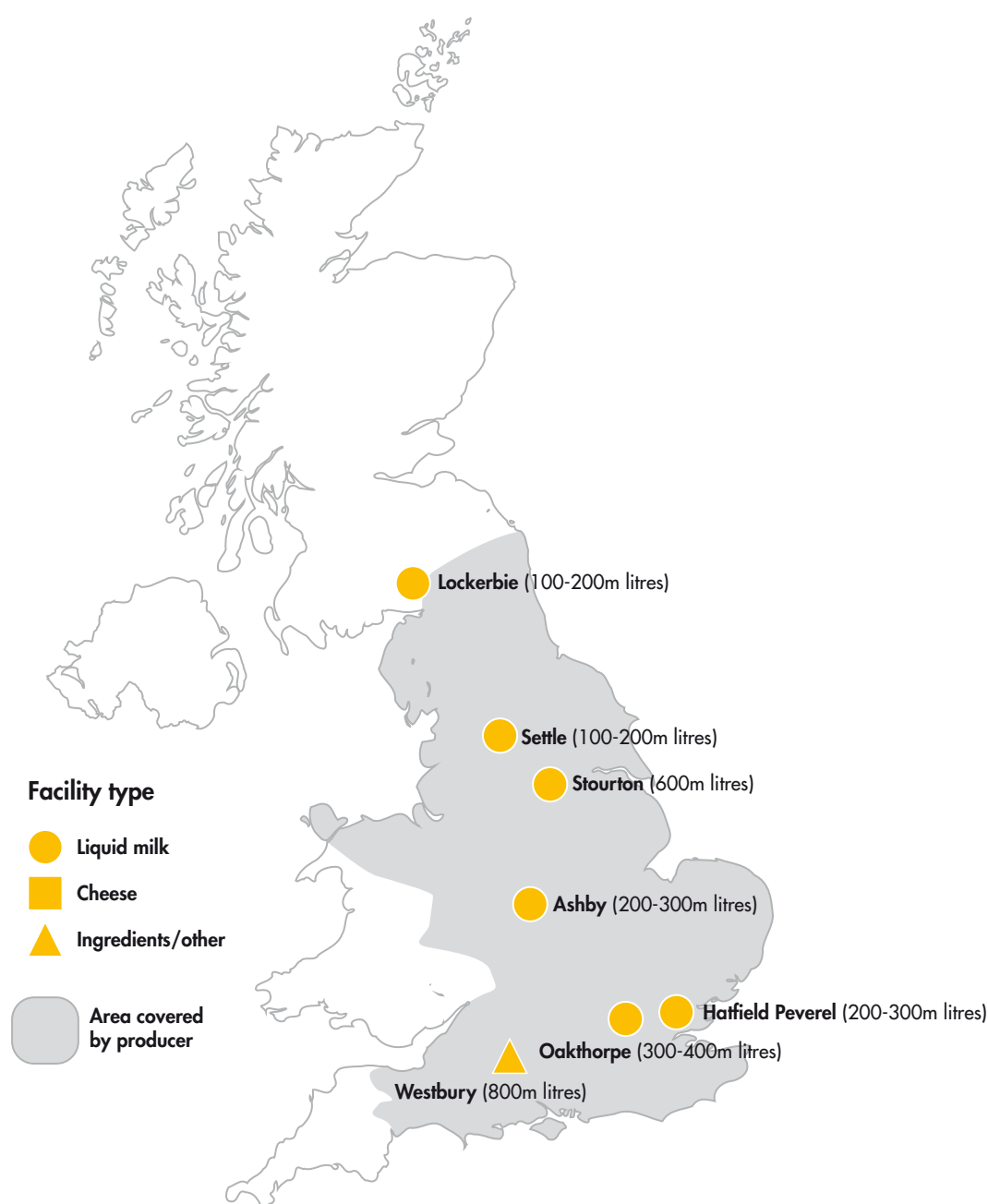
*Lost Co-operative volumes to DC & RWD in May10, Tesco share reduced to 40% in Dec10 but gained 20m litres from Sainsbury's in Oct10, and 25m litres from the Cooperative in Nov10.

The current product portfolio highlights the importance of the retail liquid milk business to Arla within the UK, which currently accounts for 77% of the UK milk volume that it processes. Another important component is branded milk, which accounts for around 17% of the milk pool and is showing good growth.

In total, Arla supplies just over 25% of the total GB fresh liquid milk market and its three main branded butter products of 'Lurpak', 'Anchor' and 'Yorkshire Butter' account for 15% of the total GB market for butter & spreads¹⁰. 'Yorkshire Butter' is the only branded butter that is produced from British milk, although Arla also produces own-label butter domestically. Both 'Lurpak' and 'Anchor' butter are imported, with 'Lurpak' produced in Denmark and 'Anchor' imported from New Zealand then packed in Denmark before being imported in the UK.

D.

Production facilities



¹⁰ Based on retail volume sales for the 52 weeks ending 21 March 2010, Kantar Worldpanel.

Arla consolidated its production facilities during 2009/10, selling off the Claymore Dairies in Nairn and moving the production of cream and crème fraîche from Northallerton to its new facility at Stourton. Investment in the Lockerbie plant increased capacity by 30m litres, bringing it up to 200m litres. With the purchase of a share in Westbury Dairies, butter production at Settle, along with butter production at two other sites in Sweden and Denmark, will cease in 2011.

D. The most prominent change in Arla's dairies will be the building of the proposed dairy in Aylesbury, which is scheduled to be operational towards the end of 2012. While there is no indication as to how this will impact on operations at its other dairies, the company has indicated that it may redistribute milk supplies to ensure the best distributional fit.

Markets

Liquid milk

The GB liquid milk market grew in volume terms by just under 1% (34m litres) to 5,030 million litres in the year ending 21 March 2010 according to Kantar Worldpanel data¹¹. For the 2009/10 milk year, Arla held just under 45% of the retailer own-label market, up from 42% in the previous year. However, due to the 9% decline in retail sales volumes which occurred during the year as discounters increased their sales, Arla has seen a drop of 7% in its sales of own-label milk to retailers.

The main changes in customer contracts are summarised below:

Retailer	Changes to contracts	Change in share
Asda	Renewed contract to August 2013	Maintained 100% share
Tesco	Contract renegotiated in December 2010	Share of own-label reduced to 40% Gained 50% share of 'Creamfields' volumes
Morrisons	Renewed contract to February 2015	Maintained 50% share
Sainsbury's	New contract to supply store expansion from October 2010	Gained 5% share
Cooperative	Contract lost in August 2010; new contract gained to supply tertiary branded 1% milk from November 2010 (25m litres)	
Aldi	Contract lost June 2010	

The filtered milk category showed strong growth, increasing by 17% in volume terms and 25% in value term with 'Cravendale' outperforming the market and increasing its market share. With the attractive growth rates for filtered milk, Arla is now facing increased competition from Tesco's 'Pure' brand which has increased volume sales over the period, a situation which is likely to continue with the investment to increase the production capacity for 'Pure' filtered milk by Robert Wiseman Dairies.

¹¹ Figures for retail sales discussed within this report are from this source and timescale unless stated otherwise.

Butters and spreads

Arla supplies own-label butter to retailers such as Tesco, Morrisons, Sainsbury's and Asda along with branded products 'Lurpack', 'Anchor' and 'Yorkshire Butter'. The only branded butter made from British milk is 'Yorkshire Butter' which has very small share of market.

The butter and spreads market grew by just over 1% in volume terms in the year ending March 2010, with all of this growth in the branded category. Arla's brand portfolio accounted for around 15% of the market in the year, which dropped slightly as sales of its flagship brands fell.

Fresh dairy products

Arla entered into the cottage cheese market in August 2010 producing 7,000 tonnes of cottage cheese for Tesco and Asda, which saw it immediately capture 55% of market volume. It plans to increase production to 10,000 tonnes by 2012. With consumer trends moving towards low fat, healthy products, the move into this market fits Arla's strategy to add value to dairy products.

Arla also produce other own-label dairy products for the retailers and have successfully retained the contracts with Morrisons and Sainsbury's to supply them with 8m and 20m litres respectively of cream, sour cream and custard.

Highlights...

- Branded products showing good growth, with 'Cravendale' outperforming market in filtered milk category.
- Gained a 55% share of cottage cheese market upon entering production, with large contracts with Tesco and Asda, with plans to increase production to 10,000 tonnes by 2012.
- Lost volume share of retailer own-label milk supply.

D. Headline figures

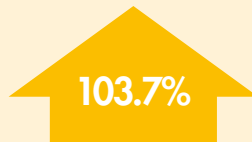
All of Arla's financial figures are based on the annual accounts of the parent company Arla Foods amba, as separate accounts are not published for the UK operations. Arla UK is an important component of the overall business, accounting for 26% of group turnover in the year ending 31 December 2009. Operating Profit figures do not include gains or losses from exceptional items. The definitions of the financial figures and ratios are available in the Appendix at the end of the report.

Operating profit...



1.4 billion DKK
year end 31/12/09

Profit before tax...



1.2 billion DKK
year end 31/12/09

Total equity...



8.4 billion DKK
year end 31/12/09

Cash flow...

Cash in: 3.4 billion DKK
Cash out: 2.4 billion DKK investments
0.5 billion finance



from previous year

- Operating profit for the group increased due to a 9.3% reduction in total costs of sales, mainly due to reduced milk prices during the financial year.
- Total turnover fell by 6.5% when compared to the previous year.
- Arla UK accounted for 26% of group turnover in the 2009 financial year (27% in the previous year), equivalent to 11.9 billion DKK (£1.5 billion).
- A combination of reduced turnover and the weakening of Sterling during the period reduced Arla UK's percentage contribution to group turnover.
- A substantial reduction in finance costs during the 2009 financial year (73.1%) has increased pre-tax profit to 1.2 billion DKK (equivalent to £143.6m) for the year.

- A supplementary payment amounting to 660 million DKK of the profits were proposed for Arla amba's co-operative members.
- Increase in equity resulted from increased group profits.
- Majority of increase in equity was transferred to delivery-based certificates which pay out to each owner upon termination of their Arla Foods amba membership.
- Increased cash received from operating activities, primarily more cash generated from profits, receivables and inventories.
- Increased cash used for investment in property and acquisitions.

Financial ratios

Profitability ratios

Gross margin 19.9%

- Gross margin up from 17.4% in previous year, comparable to similar companies.
- Although volumes up, turnover down by 6.5% due to competitive pressures in market.
- Cost of sales down 9.3%, improving margins.

Pre-tax profit margin 2.6%

- Up from 1.2% in previous year although low compared to other companies in report.
- Indicates funds available for reinvestment are limited.
- Administration costs higher on reduced turnover but balanced by lower finance costs (down 73% on previous year).

Return on capital employed (ROCE) 8.7%

- Improved from 7.3% in previous year.
- While ROCE ratio relatively low, is similar to other companies with high level of long term debt due to investments.
- Improved profits and equity in 2009 financial year, along with no substantial change in borrowing have improved returns on capital.

D.

Debt ratios

Quick ratio 0.82

- No significant change from previous year (0.85).
- Ratio in line with industry average.
- Improved cash at bank has improved short term liquidity.

Current ratio 1.13

- Down slightly from previous year (1.23) but indicates position of sufficient current assets to meet all short term borrowing obligations.
- Increased borrowings along with reduced value of stocks combine to reduce current ratio although it remains above desired 1.0 level.

Gearing 48.6%

- Small decrease from previous year.
- Relatively high level of gearing although in line with industry average.
- May be due to high level of long term funding for investment.

Efficiency ratios

Debtor days 33.7

- Minimal change from 33.2 in previous year.
- Figure is in line with industry standards.

Creditor days 28.0

- No change from previous year.
- Figure is low relative to other similar companies indicating they are quick to pay suppliers.

Stock days 35.6

- Reduced from previous year by 2.6 days.
- Stock turning over quicker which will aid cash flow.

Highlights...

- Increased profits despite challenging trading environment during financial year.
- Financial situation of parent company strong, although currently have high level of debt due to investment programme of past 3 years.
- Gearing is high although this may be due to ongoing investment projects by Arla amba.

**The Caledonian
Cheese Company.**

The Caledonian Cheese Company

Company profile.

D. The Caledonian Cheese Company Limited, The Fresh Milk Company Limited, and McLelland Cheese Packing Limited are all part of the Lactalis McLelland Limited group which is itself owned by the French dairy company Lactalis. The three companies are separate autonomous companies which sell to and purchase from each other in line with the Lactalis business model.

Fresh Milk Limited is a newly formed company in charge of all the milk procurement activities for the group. The Caledonian Cheese Company processes the milk into Cheddar cheese at its main factory in Stranraer and soft cheese at its other factory in Lubborn, Somerset¹². The packaging operations are done through McLelland Cheese Packaging Limited while Lactalis McLelland UK are in charge of the sales and marketing of all butter, cheese and cream made in the UK and those imported from other countries.

The parent company Lactalis is currently the largest natural cheese producer in Europe with ambitions to become the largest dairy company worldwide. It currently operates in 140 countries worldwide, with activities based in Western and Eastern Europe, North America, the Middle East and Australia.

Lactalis McLelland Limited, a UK subsidiary of Lactalis¹³, is primarily involved in the manufacture, import, sale and trade in cheese, butter and cream. The majority of milk purchased within Britain is used by The Caledonian Cheese Company for cheese production at its main factory in Stranraer, notably under the '*Seriously Strong*' brand. In addition, it is involved in a joint venture in the Orkney Cheese Company producing Cheddar cheese, and in the production of Somerset Brie, Camembert and '*Capricorn*' Goats Cheese at its Lubborn creamery.

In 2009, it bought the Lubborn factory, previously owned by Dairy Farmers of Britain, offering ongoing supply contracts to producers supplying the facility¹⁴. The acquisition gives Lactalis McLelland a UK manufacturing base for soft cheeses, complementing its current activities in this market and using the expertise of its parent company in this type of cheese manufacture.

Lactalis McLelland has a strategy to be number one or number two in any market it is involved in, and has strong brands in '*Seriously Strong*', '*Galbani*' and '*President*'. It maintains a balanced business between branded and own-label products, which is supported by the strong commercial network that Lactalis has in Europe and in its other major markets.

As part of its growth strategy for the UK market, it aims to develop export sales and to improve the production capability at its Stranraer site. In the next three to four years, the aim is to increase capacity and milk procurement at the Stranraer site by 70m litres to reach 390m litres processed, which should result in an increase in cheese production of 7,000 tonnes (+21%) to reach 40,000 tonnes a year.

¹² Acquired in June 2009.

¹³ Lactalis is owned by Belgium-based holding company BSA International SA.

¹⁴ Farmers Guardian, DFB's Lubborn Cheese sold to Lactalis, 8 June 2009.

In the Cheddar market, 'Seriously Strong' positions itself in the 'occasion' segment of the extra-mature Cheddar market, where it is the number one brand. In terms of the overall branded Cheddar market, it will compete with other branded Cheddar products while in the own-label market, will face competition from other Cheddar producers both imported and produced in the UK.

Current position

D.

- Caledonian Cheese produces the second biggest Cheddar brand 'Seriously Strong', and is the third largest producer of Cheddar in the UK.
- It recently diversified its activity into UK manufacture of soft cheeses by buying the Lubborn factory which gives the company a wider UK presence.
- Caledonian Cheese, through its UK parent company Lactalis McLelland, has access to resources from its global parent in terms of commercial networks, best practice, and a source of funds for investments and marketing.
- The Caledonian Cheese Company, as one of the larger milk buyers in Scotland, is mainly involved in the production of branded and own-label Cheddar, although it also sells powder.
- It operates in the highly competitive cheese market, with high discounting occurring for branded Cheddars, and import competition in the own-label Cheddar market.
- The majority of milk requirements for The Caledonian Cheese Company are procured from direct suppliers, with plans to grow over the next 3-4 years.
- Financially, Lactalis McLelland made a profit of £2.3m for the year ending December 2009 and made a dividend payment of £2.5m to its parent company.

Future challenges and opportunities

- Lactalis McLelland, the parent company of The Caledonian Cheese Company, is looking to grow through development of export sales and a focus on brand development.
- The newly formed procurement company Fresh Milk Limited will focus on the procurement of milk for its three factories, and using the expertise of the parent company, continue to work with all farmer suppliers to ensure strong relationships are maintained.
- The Caledonian Cheese Company is dependent on the performance of and growth of the UK Cheddar market.
- The long maturation of the product reduces control over margins and makes it difficult to align input costs to achievable sales value, especially within current environment in cheese markets of deep discounting.

The Caledonian Cheese Company

Procurement analysis.

D. Milk purchases

The table below gives details of the milk supply base for Caledonian Cheese¹⁵ for the Jan-Dec 2010 period.

	Direct supplies		Third party supplies	Total	Change from previous year
	Stranraer	Lubborn	Milk brokers		
Million litres	260	12	60	332	+4.7%
Numbers	175	11		186	+6.3%

Procurement for the Stranraer site has changed significantly over the past four years, moving from a situation where 80% of milk was purchased from third parties to one where 80% of milk is procured from dairy farmers on direct supply contracts. Brokered milk is currently sourced from a number of suppliers including Milk Link, Grahams and Meadow Foods.

The total milk supply from both direct suppliers and milk brokers has increased by 4.7% between 2009 and 2010. At its Stranraer factory, there was a 6.7% increase in the number of direct suppliers, producing in total 260m litres, an increase of 4.0% compared to 2009. The number of suppliers and volume supplied at the Lubborn factory has remained unchanged.

Recruitment

The Caledonian Cheese Company is looking to process 390m litres of milk at its Stranraer factory by 2013-15, an increase of 70m litres (21.9%) on current levels. The majority of this increase (60m litres) is expected to come from direct suppliers, with the company promoting pre-agreed expansion through the payment of bonuses.

Through the procurement company Fresh Milk Limited, milk for Stranraer is sourced from a radius of approximately 100 miles around the factory, which equates geographically to all of Dumfries and Galloway and along the West Coast of Scotland as far as Kilmarnock in East Ayrshire and Carlisle in Cumbria.

For the Lubborn factory, there are currently no recruitment plans. Depending on the company's investments and acquisition decisions however, there is the potential for some recruitment in the South West of England.

There are no minimum or maximum volume requirements for new suppliers, and all farm sizes and production profiles are considered. The average size of current suppliers is relatively large at 1.5m litres, although there is a wide range of farm sizes currently supplying the Stranraer facility.

¹⁵ All milk purchases for Caledonian Cheese are now done through the procurement company Fresh Milk Limited.

In terms of milk profile requirements, all production requests are considered, even the New Zealand production profile which produces for 11 months of the year. However, some seasonal profiles can attract a lower contract price than flat production profiles once seasonality payments and bonuses are taken into consideration.

Contracts

The table below summarises the main features of the supply contracts offered by Fresh Milk Ltd¹⁶ for suppliers to the Stranraer factory¹⁷. There are three contract options: Standard, Profile and Seasonal, all of which aim to be transparent and simple to understand. Which option is better will depend on the milk profiles of individual producers.

	Contract 1	Contract 2	Contract 3
Name	Standard	Profile	Seasonal
Million litres	260		
Producer numbers	175		
End use	Cheddar cheese & ingredients		
Catchment area	South-West Scotland and North Cumbria (within a 100 mile radius of Stranraer)		
Average price 2009/10 (DairyCo standard litre)	23.57ppl	24.17ppl	23.77ppl
Price reviews since year end	2 +2.0ppl		
Reasons for price changes	In response to market trends, market position and discussions with farmer committee		

(Figures relate to the milk year 2009/10)

Contracts are on-going and require 3 months notice from a producer to quit the contract, one of the lowest notice periods offered. All producers are required to provide a 6-month forward forecast. As the company is actively encouraging increased production from its current contracted farmer, bonus payments for meeting pre-arranged expansion plans are paid.

Price review

Price changes are made as and when necessary by the company and are can be in response to changes in the milk price made by competitors, market trends and discussions with the farmer committee. Price setting is not linked to commodity markets and there is no formal negotiation process in place. Price decreases are never introduced retrospectively although the company has occasionally paid a retrospective price increase.

In the 2009/10 milk year, there were two downward adjustments in price, totalling 2.25ppl. These were both in line with price adjustments made by other major buyers of milk for cheese. In the current milk year, there have been two price increases, totalling 2.0ppl, implemented in July 2010 and February 2011.

¹⁶ Fresh Milk Ltd is the procurement arm of Lactalis, who purchase all of the milk used by The Caledonian Cheese Company for use at its Stranraer and Lubborn factories.

¹⁷ No information was provided about the Lubborn contract. However, it only concerns a small number of farmers.

Exit policy

Producers are required to give three months notice to exit and can give this at any time of the year. This is a lot shorter than typically required by milk buyers.

Supplier benefits

D. The Fresh Milk Company is one of the few milk buyers paying a bonus for expansion. Pre-agreed expansion qualifies for a bonus set at between +0.1ppl and +0.4ppl e.g. 0.4ppl is paid out for pre-agreed expansion of 20%.

Direct suppliers are also offered an interest free loan in the form of an advance of up to 6 months against the monthly milk cheque. This scheme is popular with suppliers, with approximately 20-25% of producers taking up this facility at any one time.

There is a supplier group committee of seven elected producers who meet on a monthly basis with the Fresh Milk Company. Formal issues by suppliers are raised and discussed through this committee. However, Caledonian Cheese, through the procurement company Fresh Milk, make a point to remain close to its suppliers, with each producer known and contacted on a personal basis - one of the benefits of being relatively small and drawing on the expertise of its parent company in France.

Highlights...

- Caledonian Cheese paid a competitive price for a cheese contract in 2010, regularly placed in the top third of the DairyCo league table. Prices are adjusted in line with market trends, competitor's prices and in discussion with its farmer committee.
- Milk supply has increased between 2008/09 and 2009/10 by 4.7%. With expansion planned for the Stranraer creamery, there are opportunities for more direct suppliers for the facility, and possibly for the Lubborn site in the longer term.
- There are no specific size or profile requirements for potential suppliers. Current suppliers average deliveries of 1.5m litres of year, although all farm sizes are considered.
- The notice period for suppliers to exit their contract is three months which is one of the lowest in the industry.
- Producers have added benefits such as bonuses for agreed expansion and interest free loans.

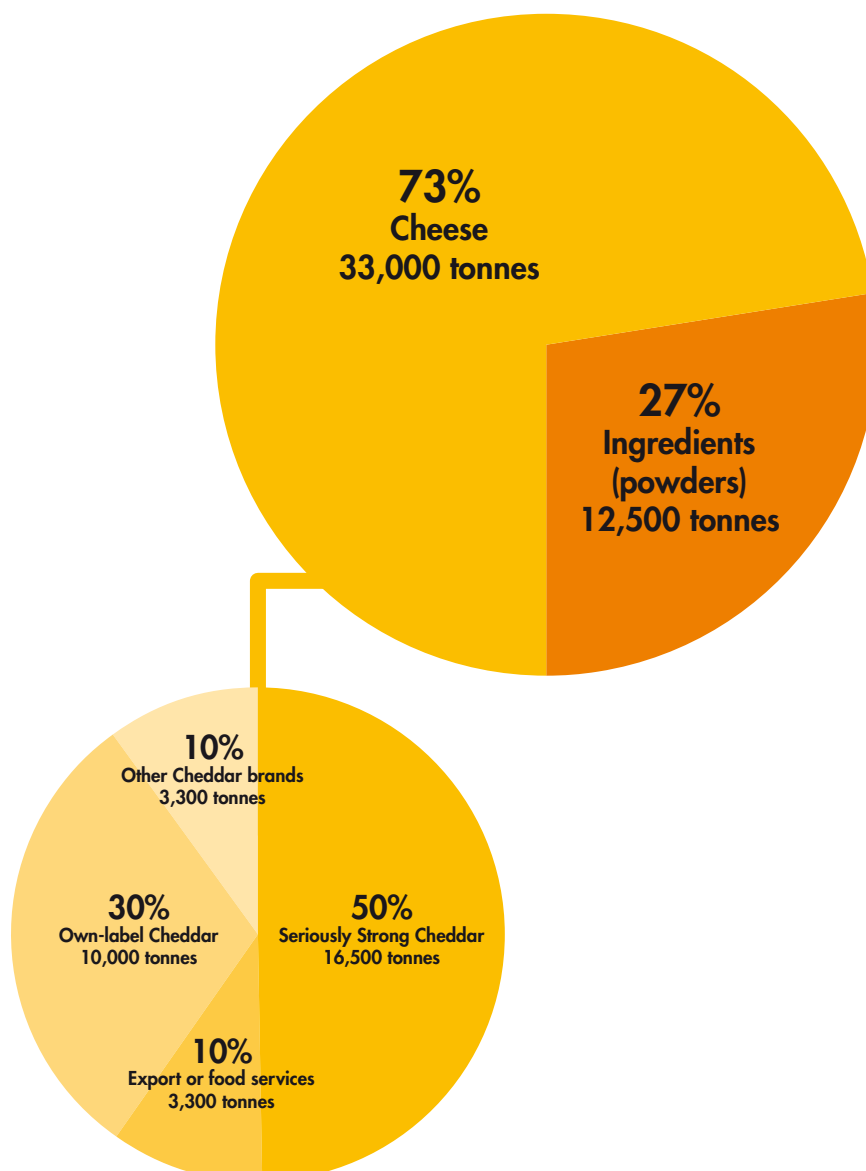
The Caledonian Cheese Company

Production analysis.

Product portfolio

This graph below provides a breakdown of products made at the Stranraer factory. Caledonian Cheese did not provide production figures for the smaller Lubbarn plant.

Total milk purchases - 320m litres

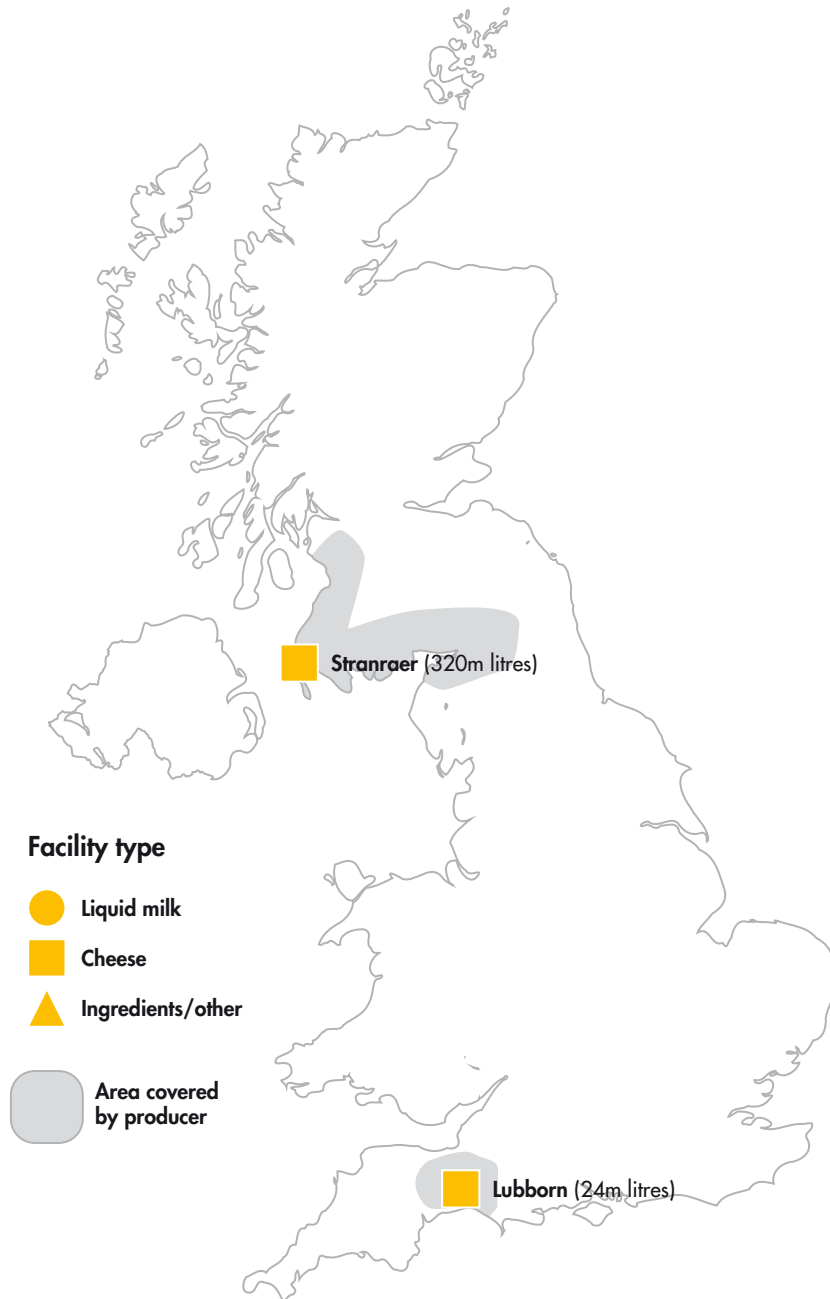


The amount of Cheddar produced is increasing year on year with 2010 production up 4.8%. The company plans to increase production to 40,000 tonnes of Cheddar by 2015, which is a 21% increase on current production levels. As part of its strategy to focus on growth in branded products, investment in brands during the 2009/10 financial year ensured that its market position was maintained, despite high levels of promotional activity by competitor brands.

Exports have expanded during 2010 with the 'Seriously' brand sold in over 40 countries worldwide. The strategy is to continue with the expansion of export sales by using the network of companies owned by the Lactalis group.

Production facilities

D.



The Caledonian Cheese Company operates two processing plants, located at Stranraer in Scotland and Lubborn in England. The largest by far is the Stranraer factory which processes Cheddar cheese and Whole Milk Powder (WMP), with a capacity to use 320m litres of milk per annum. The Lubborn factory has a capacity of 24 million litres and produces Somerset brie, Camembert and goats cheese. The Lactalis group also operate a separate dessert business in the UK in a joint venture with Nestlé (Lactalis Nestlé), who recently purchased the 'Rachels Organic' business in Aberyswyth. Milk purchasing arrangements for this facility are not included in this report. While this part of the overall business is not directly linked with the operations of Lactalis McLelland, it does provide further market opportunities for the parent company.

According to Caledonian Cheese, the Stranraer plant is running at full capacity plus or minus 1m litres, depending on the time of year. Currently the plant runs at just over 1 million litres/day for 8 months of the year and just under 1 million litres/day for the remaining 4 months.

Investments

During 2009, £1.3m was invested at the Stranraer factory, double the amount invested the previous year.

D.

Markets

The majority of The Caledonian Cheese Company's sales are of Cheddar to the GB retail market, with around 5% sold to the foodservice industry and another 5% exported. Its powders are sold to the food ingredients market, with 60% of this in the UK and 40% exported.

According to Kantar Worldpanel data, the Cheddar retail market was worth £1.4 billion in December 2010, with sales volumes up 5% and values up 4% between December 2009 and 2010. The branded Cheddar segment, which accounted for 45% of the total market, grew by 8% in volume and value terms over the period.

While '*Seriously Strong*' almost doubled its market share of the Cheddar market in value terms, it has a long way to go to challenge the dominance of '*Cathedral City*'. According to recent figures compiled by DIN¹⁸, '*Seriously Strong*' is the second largest brand in GB, although its sales value was about one-third the value of its main competitor '*Cathedral City*'. Caledonian Cheese's other brands, '*Seriously Farmy*' Cheese and '*Galloway*' cheese, have a much smaller share of the market, both below 1% of the branded Cheddar market segment, but growing.

Highlights...

- The Caledonian Cheese Company is dependent on the performance of Cheddar markets, in a very competitive market sector where discounting is prevalent, although they have a strong brand presence with '*Seriously Strong*' Cheddar.
- '*Seriously Strong*' Cheddar performed well in 2010, gaining market share, but '*Cathedral City*' is currently worth more than twice as much at retail level.
- Lactalis McLelland has new opportunities to diversify with the acquisition of Lubborn and the development of export markets.

The Caledonian Cheese Company

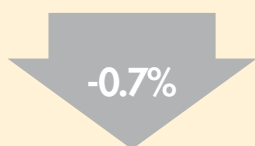
Financial analysis.

D. Headline figures

This section looks at the financial performance of Lactalis McLelland Limited as a whole, rather than just the cheese making or milk procurement components of the group. The figures will therefore also include activities such as the import and sales of continental cheese. During the period covered by the accounts, the company purchased the Lubborn factory.

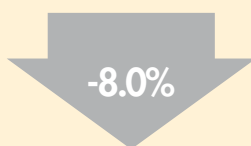
Headline financial figures and ratios have been calculated from the most recent full set of accounts for the Lactalis McLelland Limited group. Operating Profit figures do not include gains or losses from exceptional items. The definitions of the financial figures and ratios are available in the Appendix at the end of the report.

Operating profit...



£5.9million
year end 31/12/09

Profit before tax...



£2.9million
year end 31/12/09

Total equity...



£42.4million
year end 31/12/09

Cash flow...

Cash in: £23.7m

**Cash out: £8.2m investing
£4.8m financing**



from previous year

- Operating profit for the year ending 31 December 2009 is broadly the same as last year.
- While turnover and administrative costs went up as the result of the purchase of the Lubborn factory, these were offset by higher milk prices and reduced selling prices highlighting difficulties in negotiating higher selling prices from customers.
- Lactalis McLelland made a pre-tax profit of £2.9m down 8.0% from £3.2m in the previous year.
- Operating, finance and other costs remain relatively stable. The change in pre-tax profits can mostly be attributed to a small reduction in revenues from associated undertakings.

- Total equity has gone up by 5.4% compared to last year.
- Due to the nature of the company structure, all profits are added to the profit and loss account, and therefore impact directly on total equity.
- As no dividends were paid to the parent company Lactalis, the equity remains available to support the Lactalis McLelland's operations.
- Lactalis McLelland substantially increased its cash flow from operating activities from the previous year, when it was £6.5m.
- The majority of this cash was used to invest: it bought the Lubborn factory and invested £1.3m into the Stranraer factory.
- The company finished the year with a £10.7m increase in cash

Financial Ratios

Profitability ratios

Gross margin 14.9%

- Gross profit margin remained at similar level to previous year.
- This ratio is slightly lower than the other milk buyers examined in the report, although typical for companies with heavy involvement in cheese production.

Pre-tax profit margin 1.7%

- The pre-tax profit margin ratio has not changed substantially from previous year.
- The low net margin percentage is not of concern as the company holds large reserves and has support of parent company.

Return on capital employed (ROCE) 9.1%

- The return on capital employed has decreased slightly since the previous year (9.5%) as a result of a rise in capital.
- This ratio shows that the company has improved its profitability, although it is below the average for the industry.
- Capital employed is high due to amounts owed to group undertakings

D.

Debt ratios

Quick ratio 0.47

- Ratio is low and indicates that in the absence of cheese stocks, short term debt obligations would not be fully met from available liquid assets.
- Taking into account amounts owed to group undertakings, the quick ratio increases to 1.50.

Current ratio 1.52

- The current ratio is slightly lower than last year although shows a healthy liquidity position when cheese stocks are included in current assets.

Gearing 34.3%

- Gearing is at a comfortable level showing that the company has enough equity compared to its long term loans.
- It must be considered that all of the companies long term debt is owed to group undertakings, rather than commercial loans.

Efficiency ratios

Debtor days 44.2

- This stood at 37.6 days in 2008, indicating an increase in trade debt relative to turnover
- The ratio is similar to other companies within the industry.

Creditor days 22.0

- This is an improvement on the 22.8 days in 2008, (does not account for amounts owed to group undertakings).
- The company is quick to pay its suppliers.

Stock days 192.7

- Up 7.3 days from the previous year although with large proportion of production in mature Cheddar, this is not out of line.
- This increase may be the result of an increase in the value of stocks, which in turn may partly be due to higher purchase costs, may have impacted this.

Highlights...

- The 2009 financial results for Lactalis McLelland are positive with increased turnover and profits and relatively low gearing.
- Ratios suggest that the profitability of the company is comparable to other dairies operating in similar markets, although only a one part of the overall company has been assessed. Lactalis McLelland is financially stable but its success for the year examined is likely to have been affected by the challenging conditions in the Cheddar market.
- Lactalis McLelland has invested in the Caledonian Cheese factory at Stranraer and acquired the Lubborn creamery; activities which should help to diversify its activities, reduce exposure to the Cheddar market and become more efficient.

D.

D.

Company profile.

D. Dairy Crest is the UK's largest dairy company by turnover. It processes 2.1bn to 2.2bn litres of milk a year into liquid milk, cheese and butter and spreads. Approximately 72% of this milk is sourced from around 1,350 direct suppliers in England and Wales.

The company's stated aims are to promote pride in the Dairy Crest heritage and retain its position as the UK's largest dairy company whilst promoting sustainability through good stewardship and maintaining a focus on consumer needs. Dairy Crest's strategy is to improve revenues through the growth in market share, increased added value sales and reduced sales to commodity markets. It also aims to reduce costs through efficiency improvements, and to use business acquisitions and disposals to generate growth.

In order to achieve this, Dairy Crest has a number of targets, the most important ones being to increase profits year-on-year; to increase direct supply from 72% to 85%; and to make a £75m capital investment over the next 3 years to improve efficiency. For its different product segments, Dairy Crest aims to maintain overall volume sales of liquid milk but to redirect these sales from the middle ground market to major retailers. Dairy Crest also has targets to grow each of its five key brands: *'Cathedral City'*, *'Country Life'*, *'Clover'*, *'Frijj'* and *'St Hubert Omega 3'* to be number one or two in their specific segments of the market.

Recent developments from the company include the introduction of a range of new supplier contracts aligned to specific business areas, such as the 2-year fixed priced contract to supply its home delivery service *'milk&more'*. Also in 2010, Dairy Crest won new business with Lidl, the Co-operative and Tesco. From December 2010, a dedicated supply contract with Tesco (the Tesco Sustainable Dairy Group) was set up to supply 5% of its liquid milk requirement. In June 2010, Dairy Crest reduced its shareholding in its cheese production plant at Wexford to 30%, with an aim to exit the own-label/unbranded segment of the cheese market.

With activities in three main segments of the dairy market, Dairy Crest faces competition from a number of sources. In the liquid milk market, there is currently intense competition between the three largest liquid dairies (Dairy Crest, Arla and Robert Wiseman Dairies) to maintain supply volumes both in the major retail and middle ground markets. Cheese markets are also competitive, especially in the branded sector where discounting has been extensive, although there is also import competition in the own-label and value categories. *'Cathedral City'* in particular faces competition from other major Cheddar brands such as Caledonian Cheese's *'Seriously Strong'* Cheddar and Wyke Farms, although it has a strong position in the market. Butter markets are facing declining consumer demand, and with a large number of branded and retailer own-label products on the market, compete with both domestic and imported alternatives.

Current position

- Dairy Crest is the largest UK dairy company with turnover of £1.6bn.
- Is a broad based business with 22% of sales from (value-added) branded dairy products and strong brand growth over the last 3 years.
- Dairy Crest has the largest share of the GB doorstep delivery business.
- The Spreads category was the most profitable segment of the business in 2009/10, returning larger margins than the liquid or cheese segments.
- 72% of milk is procured on direct supply contracts.
- Dairy Crest has supply contracts with 6 of the 7 major retailers and two key middle ground players.
- Limited scope for winning new retailer aligned supplies as many retailers have recently signed long-term contracts.
- Supply base and processing infrastructure is located in key areas across England and Wales.
- 75% of sales from commodity milk – with high dependence on sales into the retail and middle markets where there is currently strong competition, notably from Arla and Robert Wiseman Dairies.
- Strong brand portfolio amongst dairy products – number one and number two positions for 5 key brands.
- A profitable company but high debts and large pension deficit.

D.

Future challenges and opportunities

- Looking at recruiting more direct suppliers but will face the competition of other milk buyers.
- Aiming to improve profitability of liquid milk business by growing proportion of liquid milk directed to large multiples and 'milk&more', and reducing volumes to middle-ground markets.
- To keep pace with competitor investment activities in liquid milk, it will need to ensure sufficient investment in current production facilities.
- Will need to address the challenge of reducing its debt and its pension deficit.
- Is competing with globally funded and resourced dairy companies in the pursuit of added-value opportunities and market share (through brand development, innovation and acquisition).
- The intense competition in both the liquid and dairy products sectors is likely to continue in the near future.
- Looking to expand business through targeted dairy acquisitions in Europe (esp. France or Italy) or complementary activities in the food industry in the UK.

Procurement analysis.

D. Milk purchases

The table below gives details of Dairy Crest's milk supply base for the 2009/10 milk year.

	Direct supplies		Third party supplies	Total	Change from previous year
	Aligned	Non-aligned	Co-operatives and other brokers		
Million litres	850	720	615	2,185	+4.0%
Numbers	700	700		1,400	no change

There have been no major changes in the number of suppliers or deliveries between 2008/09 and 2009/10. Milk supply from direct suppliers increased by 40m litres (+3%) from 1,530m to 1,570m litres but as the number of suppliers did not change, the growth will have come from expansion of current suppliers.

Recruitment

Dairy Crest will need to increase direct supplies by around 280m litres over the next three years in order to meet its target to move from 72% to 85% direct vs. brokered supply. It is encouraging existing suppliers to expand, in particular to meet growing cheese sales. For producers supplying milk procured for Davidstow, a premium is paid for milk produced over and above forecasted deliveries.

Dairy Crest's immediate recruitment plans focus on Wales, the South of England and the Midlands. When recruiting, Dairy Crest looks at 'logistical optimisation', meaning new suppliers need to be 'logistically convenient to a processing plant'. With current suppliers' average production at 1.1m litres, Dairy Crest tend to have larger suppliers. Dairy Crest stressed that *'We do not look for farmers of a certain size but we do look for farmers of a certain standard. We will buy from all types of farm and all methods of farming but suppliers have to be good at what they do.'*

The proposed 'Farm Business' contract will offer a premium to suppliers producing 3m litres or more per year in order to reflect savings made from economies of scale in collection. The introduction of this type of contract indicates Dairy Crest's interest in attracting large farms.

In terms of production profile, as 78% of its sales are into the liquid milk market, Dairy Crest prefers producers with a flat profile (i.e. +/- 10% seasonality) as this best aligns with the requirements of its customers. Consequently, farmers with a flat production profile will realise a better price than those who supply based on a traditional seasonal pattern.

Contracts

	Davidstow	Liquid non-aligned	Sainsbury's	M&S	Waitrose
Million litres	470	720	210	70	100
Producer numbers	400	700	200	40	60
End use	Cheese	Liquid	Liquid	Liquid	Liquid
Catchment area	Cornwall & Devon	England & Wales – not far North	England & Wales – not far North	Cornwall	England & Wales – not far North
2009/10 average price (DairyCo standard litre)	24.18ppl	24.05ppl	25.75ppl	27.44ppl	27.38ppl
Price changes Apr-10 to Feb-11	3 +2.25ppl	2 +1.42ppl	3 +1.50ppl	3 +1.905ppl	1 +1.00ppl
Reasons for price changes	Company performance and market returns			Formula based on production costs and retail market	Company performance and market returns

Figures relate to the milk year 2009/10

In 2010, Dairy Crest introduced two new contracts, and aim to launch another in the near future. It launched the 'milk&more' contract in March to supply the doorstep division. The principle of this contract is that the price is fixed for a 2 year period. It started at 0.25ppl above the prevailing price at the time, and the price is then tracked on a monthly basis against an agreed 'Market Price Basket' of Dairy Crest, Arla and Wiseman non-aligned liquid milk prices. If the variance against the basket price is +/-2ppl, a review of the price is triggered. The purpose of the fixed price contract is to provide greater stability to suppliers and to secure supplies for the doorstep division of the business.

The proposed new Farm Business contract will be available to suppliers on non-aligned contracts that produce more than 3m litres. After accounting for bonuses paid for higher deliveries, this contract will offer a higher price than the standard pricing schedule. From December 2010, Dairy Crest will also operate an aligned liquid contract to supply its new Tesco business. The contract represents 50m litres per year which will be supplied by both core and seasonal suppliers. The latter will only be paid the Tesco price for a proportion of the milk they produce.

Price review

Price changes are decided through discussions between Dairy Crest and Dairy Crest Direct (DCD), the organisation representing the 1,350 farmers on direct supply contracts. Meetings take place once a month, and price reviews are triggered mainly by Dairy Crest realisations in terms of costs of production, supply and demand and market prices. Producers are given two weeks notice of price changes, and retrospective downward price movements are not made.

D.

Since the end of the last financial year, there have been a number of price adjustments to the Dairy Crest contracts. The Davidstow contract, which buys milk for producing Cheddar, has seen the largest increase, up by 2.25ppl. For the liquid contracts, both the non-aligned and Sainsbury's aligned contract received an additional 0.42ppl in August 2010, followed by two further increases on the Sainsbury's contract in October and December 2010. The December increase of 0.60ppl was implemented by Sainsbury's to account for the rising costs of feed faced by dairy farmers.

D.

Exit policy

Producers are required to give twelve months notice to quit and are able to put in their notice at the end of any month. Producers are still eligible for bonuses whilst under notice. Dairy Crest is required to give twelve months notice to stop the contract.

Farm assurance

Requirements will vary by individual contract as different customers have different requirements. Generally, Dairy Crest asks for slightly higher 'Country Life' standards but most of the farmers supplying Dairy Crest are already meeting these standards.

Supplier benefits

Dairy Crest offers a wide range of initiatives to help producers get the most out of their business, including advisory services through a group of contracted consultants, White Gold, and regular farmer meetings. These services are offered at Dairy Crest's cost.

Launched in January 2010, Dairy Crest and DCD set up Agri-Assist, a joint venture which offers group purchasing, a carbon measurement tool and other services such as sourcing alternative feed ingredients.

Highlights...

- In 2009/10 the price paid for milk on Dairy Crest's non-aligned liquid contracts was very similar to its two competitors Arla and Wiseman. The Davidstow cheese contract was paid the highest average price for a cheese contract on the DairyCo League Table during the year.
- Dairy Crest aims to increase direct supply by an extra 280m litres over the next three years. Recruitment will be focussed on Wales, the South of England and the Midlands.
- Although the company states that it does not recruit based on farm size, Dairy Crest suppliers average 1.1m litres a year suggesting that its farms are larger than average. It is also strict on whether a farm is in the right geographical area for collections.
- Dairy Crest suppliers benefit from the help of Dairy Crest Direct which represent them in price negotiations and provide a range of services.

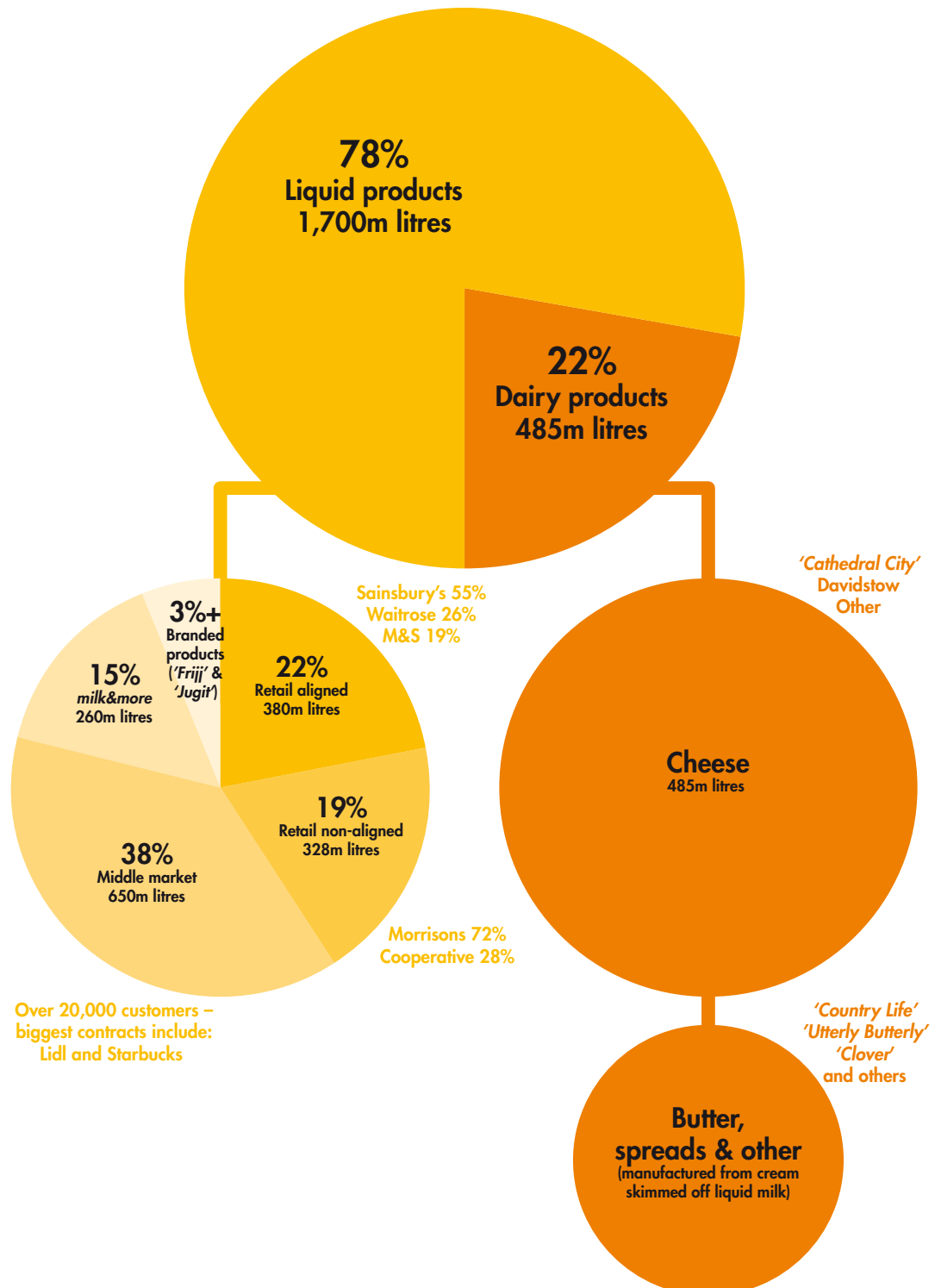
Dairy Crest

Production analysis.

D.

Product portfolio

Total milk purchases - 2,185m litres



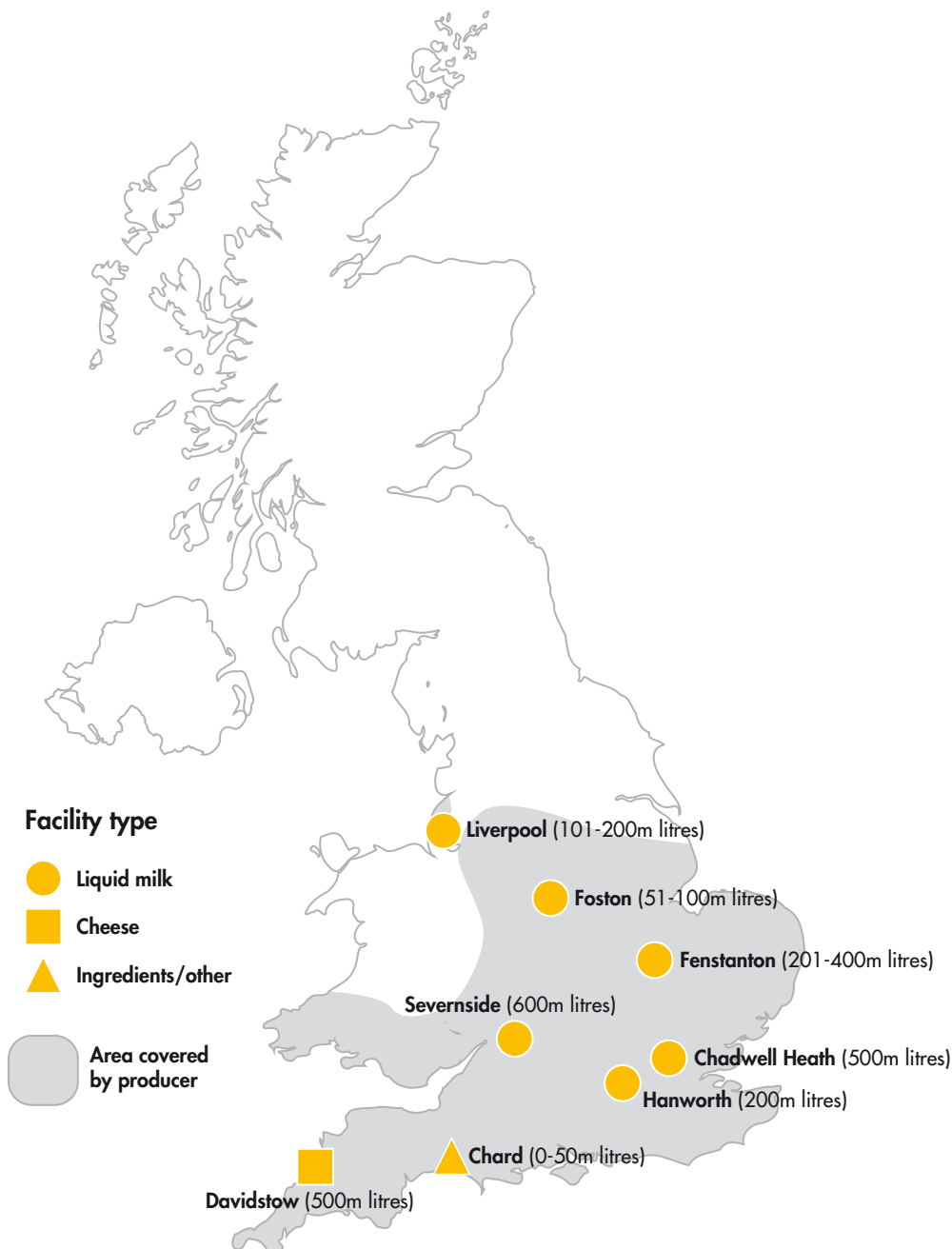
Note: Retailer percentages refer to share of each retailer’s milk supply requirements
*Estimates based on information provided by Dairy Crest and Kantar Worldpanel data

There have been no major shifts in how Dairy Crest allocate its milk between its main products in the year, although it aimed to reduce its involvement in commodity products. The majority of milk is diverted to liquid milk, cheese and butter or spreads.

The current product portfolio highlights the importance of the liquid milk commodity business to Dairy Crest which currently accounts for 75% of its business in volume terms with just 3% attributed to added-value products in the liquid milk sector. The excess cream obtained from the liquid business is used in the production of its cream, butter and spreads products.

Dairy Crest is keen to reduce exposure to the more volatile middle ground sector which currently accounts for an estimated 30% of its total milk pool and around 40% of liquid milk sold. Currently 22% of milk procured goes into dairy products with one in five litres procured (20%) going into cheese production at Davidstow.

Production facilities



Dairy Crest's processing sites are predominantly for liquid processing, with 6 liquid milk processing plants, one cheese processing facility and one facility producing butter, cream and powder. In 2009/10 it disposed of its majority stake in Wexford Creamery Limited.

Dairy Crest's decision to consolidate its activities to increase profitability rather than increase volumes of milk procured over the next three years means that it should have adequate capacity to meet its business goals and objectives in the liquid milk and cheese sectors.

Investments

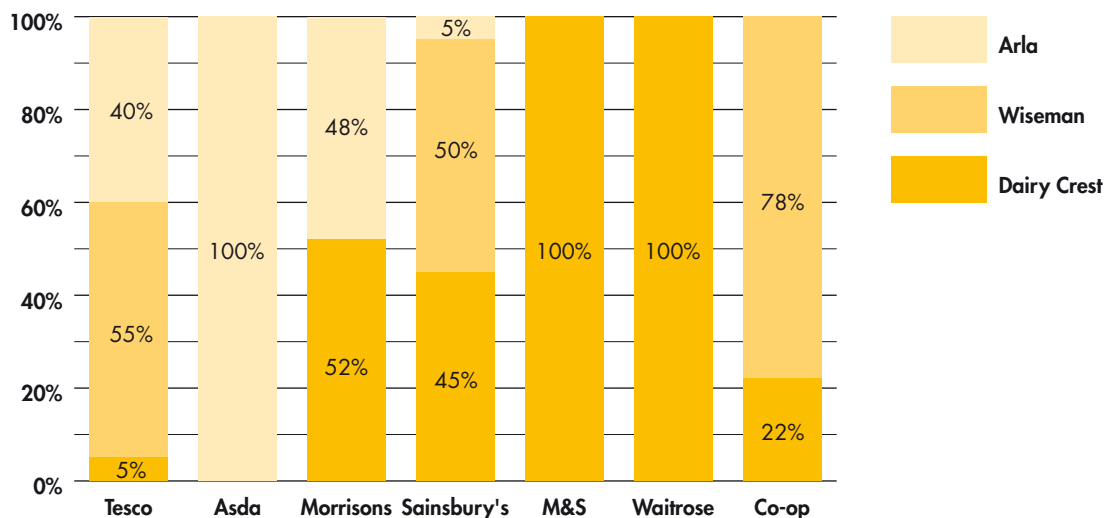
Dairy Crest plans to invest £75m into its liquid milk facilities between 2010 and 2012, at an average of £25m per year. There are investment plans for a £13m upgrade to facilities at Severnside and increased processing and cold storage capacity at Chadwell Heath (£4m). In addition, Dairy Crest plans to invest £3m for biomass boilers at Davidstow. The operational focus of these investments is to reduce waste, increase production efficiency and enhance supply chain planning.

Markets

Liquid milk

Kantar Worldpanel data puts the size of the GB liquid milk market for the year ending March 2010¹⁹ at 5.03 billion litres, an increase of 34m litres (1%) over the previous twelve month period. Based on Dairy Crest's estimated volume sales into the liquid milk market, this would suggest that it had a 34% share of the liquid milk market in 2010, unchanged from its position in July 2009.

Dairy Crest's share of the major retail liquid milk market as of December 2010 by customer is shown below. Including the recently acquired Tesco contract (December 2010), Dairy Crest is estimated to have a 22% overall share of the retail liquid milk market (as defined below), up from 20% prior to the commencement of the Tesco contract. Dairy Crest states that its sales of liquid milk to major retailers increased by 8% compared to the previous financial year.



Source: Dairy Crest

¹⁹ all references to 2010 data are for the 52 week period ending 21 March 2010.

Currently, Dairy Crest is a significant supplier to the middle ground market²⁰, with over 20,000 customers. This includes fulfilling 90% of Lidl's liquid milk requirement and 100% of Starbucks Coffee UK liquid milk requirement.

Dairy Crest's third main market segment in liquid milk is doorstep delivery under the '*milk&more*' banner. Dairy Crest supplies some 260m litres of liquid milk through its direct doorstep delivery service to approximately 1.3m households. Doorstep delivery has been in long term decline and currently accounts for around 5% of liquid milk sales, down from 6% in 2009.

Dairy Crest states that its flavoured milk product '*Frijj*' has increased in volume terms by 14% in the twelve months to March 2010. This out-paces the market sector growth of 10% and has enabled it to gain market share.

Cheese

The British Cheddar cheese market was worth £1,317m in the year ending March 2010. In its annual report, Dairy Crest state they have a 40% value share of the GB branded Cheddar market sector, with 36% from sales of '*Cathedral City*' and 4% from sales of Davidstow Cheddar.

Within its cheese business, Dairy Crest is heavily dependent on sales of its flagship Cheddar brand, '*Cathedral City*'. According to Dairy Crest, in the year ended March 2010, 81% of cheese sales came from '*Cathedral City*', up 18% in volume terms and 12% in value terms, largely due to the growth of its Extra Mature and Mild Cheddar variants. Kantar Worldpanel data shows that the Cheddar sector has grown by 2% in value terms to £1.32m, and by 6% in volume terms during the 2009/10 financial year. The relatively larger growth rate of '*Cathedral City*' means that it has increased its share of the market.

According to Dairy Crest, the Davidstow brand has increased in volume by 21% and in value by 7% in the year ending March 2010, also outperforming market growth in this sector and gaining market share.

Butters and spreads

Kantar Worldpanel values the GB Butter and Spreads market at £1,091m for the year ending March 2010, with volumes up by 1.2% but total value down by 1.4%. Key growth products for Dairy Crest in this sector are '*Clover*' and '*Country Life*'. '*Clover*' has increased in value terms by 5% and 13% in volume terms over the period, while '*Country Life*' has increased by 4% in value terms and 6% in volume terms²¹. According to Dairy Crest this has been off-set by a decline in sales of '*Utterly Butterly*', which were down 27% in value terms and 21% in volume terms. Other brands, '*Willow*' and '*Vitalite*' have maintained sales and volume levels year on year.

²⁰ The middle ground market consists of convenience stores, discounters and freezer centres, traditional retailing, independents, garage forecourts, coffee shops and hospitals.

²¹ Dairy Crest figures

Highlights...

- The key factor to succeed in the liquid milk sector will be to have efficient factories. Dairy Crest has planned to invest £75m in its liquid milk facilities over the next three years. It remains to be seen if this will be enough to compete against Arla and Wiseman who have already some very efficient factories and also plan to invest heavily in the near future.
- The liquid milk market is the main segment for Dairy Crest in turnover terms and in terms of amount of milk processed but not in terms of profitability. It represents 78% of the milk procured, 66% of the total turnover but only 33% of profits.
- 45% of the milk that goes into liquid milk is sold to the retail market, 40% to the middle-market and 15% doorstep. Dairy Crest aims to sell more milk to retailers at the expense of the middle market. It recently managed to do so by gaining business from Tesco but faces intense competition from Wiseman and Arla.
- In the cheese sector, Dairy Crest is reliant on the performance of '*Cathedral City*' which accounts for 81% of Dairy Crest's value sales in the cheese sector. Despite the competition from other brands and from cheap imports, this brand enables Dairy Crest to dominate the market: '*Cathedral City*' is by far the largest brand and outperformed the market in 2009/10. Although 2009/10 was a difficult year in the cheese market, Dairy Crest made a profit margin of 6.5% on its cheese segment, highlighting its strength in that sector.
- Spreads is another strong performing segment for Dairy Crest with a profit margin of 19.5% in 2009/10. Despite this, this sector is facing a stagnating or declining market in the UK and abroad and competition from rivals Arla and Unilever will most likely make it difficult for Dairy Crest to improve on its already strong revenues and profit margin.

D.

Financial analysis.

D.

Headline figures

Headline financial figures and ratios have been calculated from the most recent full set of accounts for Dairy Crest. Operating Profit figures do not include gains or losses from exceptional items. The definitions of the financial figures and ratios are available in the Appendix at the end of the report.

Operating profit...



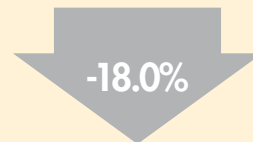
£96.6million
year end 31/03/10

Profit before tax...



£73.8million
year end 31/03/10

Total equity...



£292.8million
year end 31/03/10

Cash flow...

Cash in: £113.4m from operating activities
£12.6 from investments

Cash out: £28.8m investing
£176.9m financing



from previous year

- Operating profit (excluding exceptional items) has improved from last year due to an almost fourfold increase in profits from its liquid milk division, likely on the back of high cream prices.
- The enhanced performance of the liquid division has been partly offset by lower profits from the cheese and spreads division which experienced a challenging year, especially in cheese markets where discounting reduced the value of sales.
- As for most dairies, turnover and cost of sales were lower than last year because of lower milk prices and dairy product selling prices.
- Profit before tax fell by 3.9% partly due to the sale of its 49% stake in Yoplait in March 2009 and from reduced financial income from its pension fund during the year.
- Spreads and butters accounted for 51% of profit, liquid milk 33% and cheese 16% in March 2010.

- While pre-tax profits are lower than last year, they are higher than in earlier years.
- Equity is down £64.2m since March 2009.
- The fall in equity is mainly due to the large increase in the pension deficit that year which has weakened Dairy Crest's financial position.
- Dairy Crest has introduced a number of initiatives to reduce its pension fund risk including closing the scheme to future accrual from March 2010.
- Cash generated from operating activities increased by £20.9m compared to 2008/09 showing a better trading performance.
- Most of the cash earned from investments came from the disposal of property, plant and equipment.
- Cash used for financing was primarily used to reduce debt (down £78.6m from previous year total of £415.8m), and dividends of £24.3m were paid. Half year results (30 September 2010) show a further £16.4m decrease in long-term debt.

Financial ratios

Profitability ratios

Gross margin 29.6%

- 1.2 percentage points higher than last year, indicating that trading performance has improved.
- This ratio is the highest among the companies investigated showing that the company is very efficient at turning raw milk into income, perhaps due to its high level of branding.

Pre-tax profit margin 4.8%

- Reduced from 2008/009, when it stood at 6.2%.
- This has been impacted by the reduction in the value of assets held for sale.
- While reduced, the ratio still shows that the company is competitive in the market place.

Return on capital employed (ROCE) 14.2%

- Improvement on the 10.1% achieved in 2008/09.
- Higher operating profit along with the reduced level of long-term debt has improved situation.
- This ratio highlights that the company is efficient in generating income from its invested capital.

D.

Debt ratios

Quick ratio 0.63

- Has declined compared to the previous year where it stood at 1.0, likely due to the decrease in cash at the bank.
- The ratio is in line with similar companies, and impacted by activities in the cheese sector which require the holding of cheese stocks.

Current ratio 1.26

- Has been reduced from 1.82 in 2008/09, and is in line with the industry average.
- Company holds sufficient short term assets to meet short term liabilities.

Gearing 56.7%

- Reduced from 60.8% of 2008/09.
- The gearing ratio shows that Dairy Crest is carrying a relatively high level of long-term debt compared to its total equity, although it is declining.

Efficiency ratios

Debtor days 26.6

- No change from previous year, and much lower than the industry average of 41, indicating efficient debt management practices.

Creditor days 23.1

- There is no change in the number of days taken to pay creditors from previous year.
- This figure is low in comparison to other companies indicating they pay suppliers quickly.

Stock days 36.5

- 12.3 days lower than last year.
- With cheese accounting for the majority of stocks, the fall is primarily due to lower stocks of cheese.

Highlights...

- Dairy Crest benefits from its spreads of products. In 2009/10, the company made a good return from its liquid milk business while the year before, its cheese business performed well. This spread reduces the risks of volatile markets. Dairy Crest however has reduced its involvement in commodity products such as powders which means that it cannot benefit from this market when it is strong. The company took the view that in the long term, added-value products are more profitable than commodities.
- The high return on capital ratio indicates that the company is performing well in the market place, although this may be partly due to its operations in the French market. The strength of its branded products will have helped to increase returns. On the other hand, Dairy Crest has a relatively high level of debt and faces a pension deficit which has weakened its financial position in 2009/10.
- The balance sheet shows that Dairy Crest's tangible assets have been falling in recent years as a result of its decision to consolidate its activities. The decision to invest £75m in its liquid milk facilities over the next three years will go some way towards addressing this but it remains to be seen if it will be enough to compete against rivals Arla and Wiseman.

D.

Company profile.

D. First Milk is a farmer owned co-operative with around 2,500 members in 2009/10, making it the largest British dairy company in terms of supplier numbers. The principal activities of the co-operative are the collection and marketing of milk, along with the manufacture of cheese and dairy ingredients.

According to its 2010 Trading Update, the coop has laid out the following strategy: *"...to drive shareholder returns, grow our brands, diversify our product and market mix, lower our cost base and seek value in partnerships."* The main short term goal of the co-operative in its attempt to improve returns has been to focus on cutting costs. First Milk did not state any short term goals regarding the other areas outlined in their strategy.

Following the losses reported in the 2008/09 financial year, First Milk put a new management team in place during the second half of the 2009/10 financial year and reported a small profit for the 2009/10 period. The sale of one third of its Wiseman shares in November 2009, worth £18.6m, helped the co-operative to reduce its overall debt and finance costs. In the current financial year, the co-operative has announced a payment of 3% on member's investments, which it states is possible due to *"continued improvements in trading performance"* although the milk price paid remains at the bottom of the DairyCo league table.

As part of the co-operatives aim to reduce costs and improve efficiencies, the Isle of Bute factory and the whey processing plant at Maelor were closed in 2010. The Campbeltown factory will be closed and work started on a replacement facility during 2011. Its shareholding in Westbury was reduced in September 2010 to 59% (from 66%) due to the sale of shares to Arla.

First Milk faces competition from other raw milk brokers, and as many liquid milk processors are aiming to increase direct suppliers, may see the demand for brokered milk decline. In the cheese market, First Milk will face competition from other commodity cheese makers such as Milk Link, but also imported supplies of commodity cheese, such as exports from the Republic of Ireland.

Current position

- First Milk remains the largest milk buyer in GB in terms of the number of suppliers and volume of milk collected.
- It has strong historic links with the major liquid dairies to provide milk for balancing.
- The majority of its milk is directed towards markets with historically low returns such as brokering, non-branded cheese and dairy ingredients.
- Market returns do not appear to have benefitted greatly from high commodity prices although the co-operative has the ability to divert its milk into a variety of products to exploit movements in commodity prices.
- Would require a programme of investment to gain efficiencies and to move to higher value products, which requires time and capital.
- Its financial position has been weakened due to low turnover and high operating costs over the past three years, although some improvements in cost control have occurred in the past year under new management.
- It has lost both members and volumes, thereby reducing its ability to raise capital for investment.

D.

Future challenges and opportunities

- The new management team is taking steps to make the business more efficient and reduce costs with closure of small facilities and modernisation of Campbeltown.
- Is actively looking for opportunities for mergers and acquisitions to strengthen company in marketplace.
- Has the ability through Westbury to take advantage of the continued strength of commodity markets with world supply shortages anticipated for 2011 by diverting milk away from less profitable sectors.
- Risk of reduced milk supplies as members are paid one of the lowest milk prices and may look for alternative markets or may exit milk production.
- Reduced membership will impact on volumes and available capital which could reduce ability to finance required investments.
- Risk of shrinking market for brokered liquid milk as main dairies looking to increase direct supply.
- Needs to improve financial performance to ensure continued access to long-term funding for capital investment.

Procurement analysis.

D. Milk purchases

The table below gives details of First Milk's milk supply base for the 2009/10 milk year.

	Direct supplies		Total	Change from previous year
	Aligned	Non-aligned		
Million litres	45	1,685	1,730	-1.1%
Numbers	60	2,440	2,500	-3.8%

First Milk's milk supply was 20m litres lower in 2009/10 than in 2008/09 at 1,730m litres with producer member numbers dropping by 60, despite more than 100 farmers recruited after the collapse of Dairy Farmers of Britain (DFoB) in June 2009.

Recruitment

First Milk stated that while it is not actively recruiting new members, it will be looking to replace those leaving through retirement and always considers any farmer interested to join them. The criteria First Milk use for recruitment is primarily size and location. Farmers must supply a minimum of 1,000 litres per day, and must be located within existing First Milk milk fields. Ideally, First Milk is more interested in autumn calvers. There are currently no restrictions on expansion from members, with no plans to introduce volume restrictions in the future.

Contracts

	Contract 1	Contract 2	Contract 3	Contract 4
Name	Liquid	Compositional	Highlands & Islands	Tesco
Million litres	980	655	50	45
Producer numbers	1450	930	60	60
End use	Liquid	Cheese and ingredients	Cheese	Liquid
Catchment area	Central Scotland, England and Wales		Highlands & Islands	Wales
2009/10 average price (DairyCo standard litre)	21.44ppl	21.20ppl	22.48ppl	26.34ppl
Price changes Apr-10 to Feb-11	5 (+2.20ppl)	4 (+2.05ppl)	6 (+2.65ppl)	3 (+1.13ppl)
Reasons for price changes	Market related			Promar cost tracker

Figures relate to the milk year 2009/10

Since April 2010, First Milk launched a new contract system with market related pricing, linked to market returns and accounting for haulage costs. For milk directed towards its cheese sites, a protein bonus applies. First Milk now offers three distinct end-use linked contracts, one for cheese, one for liquid and one for balancing (either milk or cheese). The Highlands and Islands contract remained, although it is comparable to the cheese contract. The new contracts offer bigger bonuses for larger volumes, indicating that First Milk is looking to concentrate milk collections and lower costs.

In addition to these market related contracts, there is a Tesco aligned contract for milk supplied to Tesco's stores in Wales which operates in the same manner as other Tesco aligned contracts.

Price review

Being a co-operative, members receive returns in the form of the milk price and a return on member capital. Farmgate prices are set by the First Milk board which has 6 elected farmer directors out of 11 board members in total, which gives farmer directors a majority of votes.

Since the re-alignment of its milk contracts, prices are directly linked to market returns in the various markets. The cheese contracts have seen the largest net increase in price in the current milk year, with 6 price increases totalling 3.15ppl, including the most recent increase of 1.25ppl effective February 2011. The Highlands and Islands contract, which also supplies milk for cheese, has had a similar evolution of price increases, although its most recent increase was 0.75ppl, making the total price rise 2.65ppl. The balancing contract has had 4 price increases in the current milk year, with a net increase of 2.05ppl, while the liquid contract has increased by 2.2ppl after 5 increases.

The Tesco aligned contract price changes on a six-monthly basis, in line with

D.

the Promar cost tracker. In January 2011, an extra increase was announced of 0.32ppl to take account of the rising feed costs, bringing the total price increase on the Tesco contract for the current milk year to date to 1.13ppl.

In addition to the milk price paid, members of the co-operative receive a return on their member capital. There was no dividend paid in the 2009/10 year, but a return will be paid out in January 2011 at an annual interest rate of 3% for active and retired members.

D.

Exit policy

Farmers are required to give 12 months notice, with 3 exit dates of end of March, end of September and end of December. Effectively this means there could be up to 18 months of notice required, which is one of the longest in the industry. In September 2010 First Milk introduced an optional 6 month notice period where members can buy themselves out by paying 2% of the previous 12 months milk cheques. Exit periods for this are at the end of March and September.

Farmers benefit from an evergreen contract meaning that First Milk cannot give notice to its members.

Supplier benefits

First Milk operates a number of schemes aimed at helping its members. The First Milk Academy aims at increasing efficiencies on farm and improving business practices through discussion groups, workshops and benchmarking. This appears to be popular amongst members with around 40% of members engaged in the Academy. In April 2010, First Milk formed a partnership with Anglia Farmers, the UK's largest agricultural purchasing group, which enables members to source a large range of agricultural inputs, business products and services. Over 600 farmers have signed up to this scheme.

Highlights...

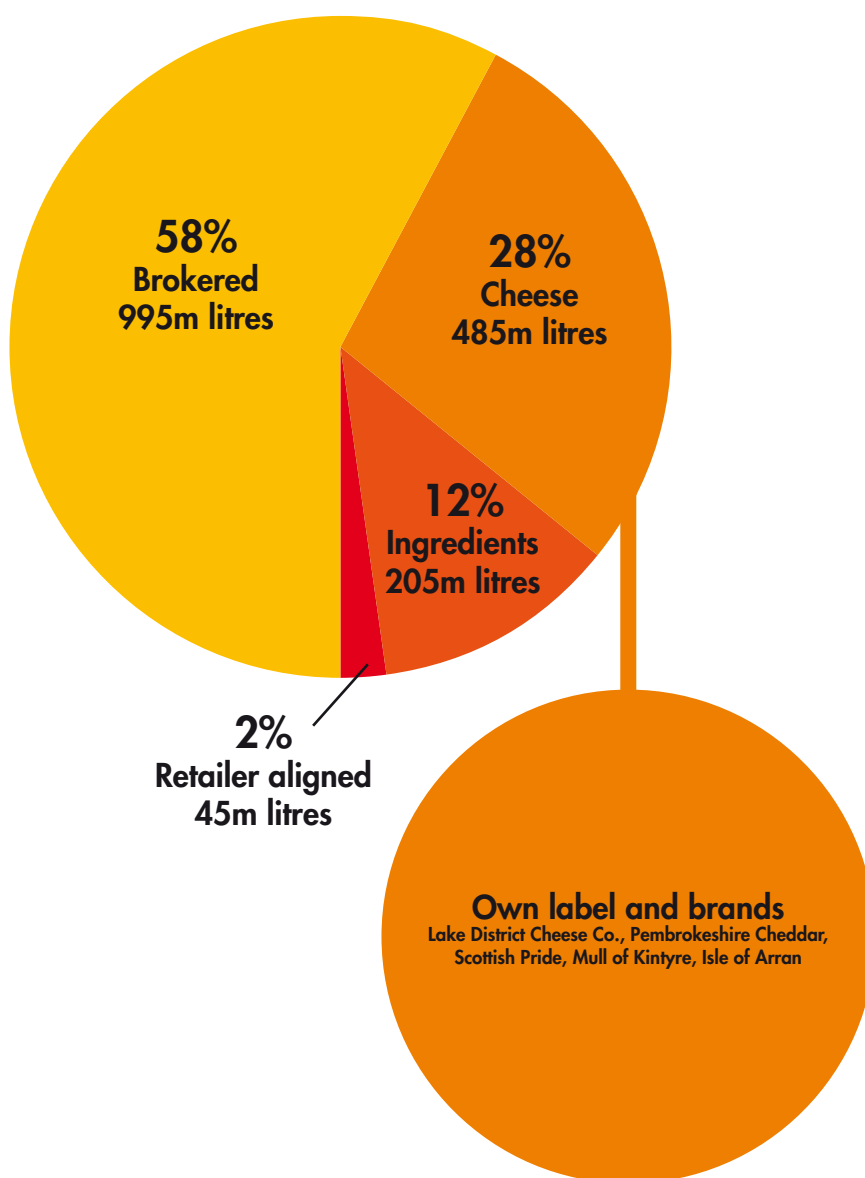
- First Milk pay the lowest price among the companies investigated in this report. However since the introduction of its new contract structure, it has moved up the DairyCo milk price league table.
- Milk supply was down slightly at 1,730m in 2009/10 compared to 2008/09 despite more than 100 farmers recruited after the collapse of DFoB on June 2009.
- First Milk look to recruit members within existing milk fields with over 1,000 litres per day.
- Additional benefits offered through the Academy and partnership with Anglia Farmers which helps members to improve their business and reduce costs.

Production analysis.

Product portfolio

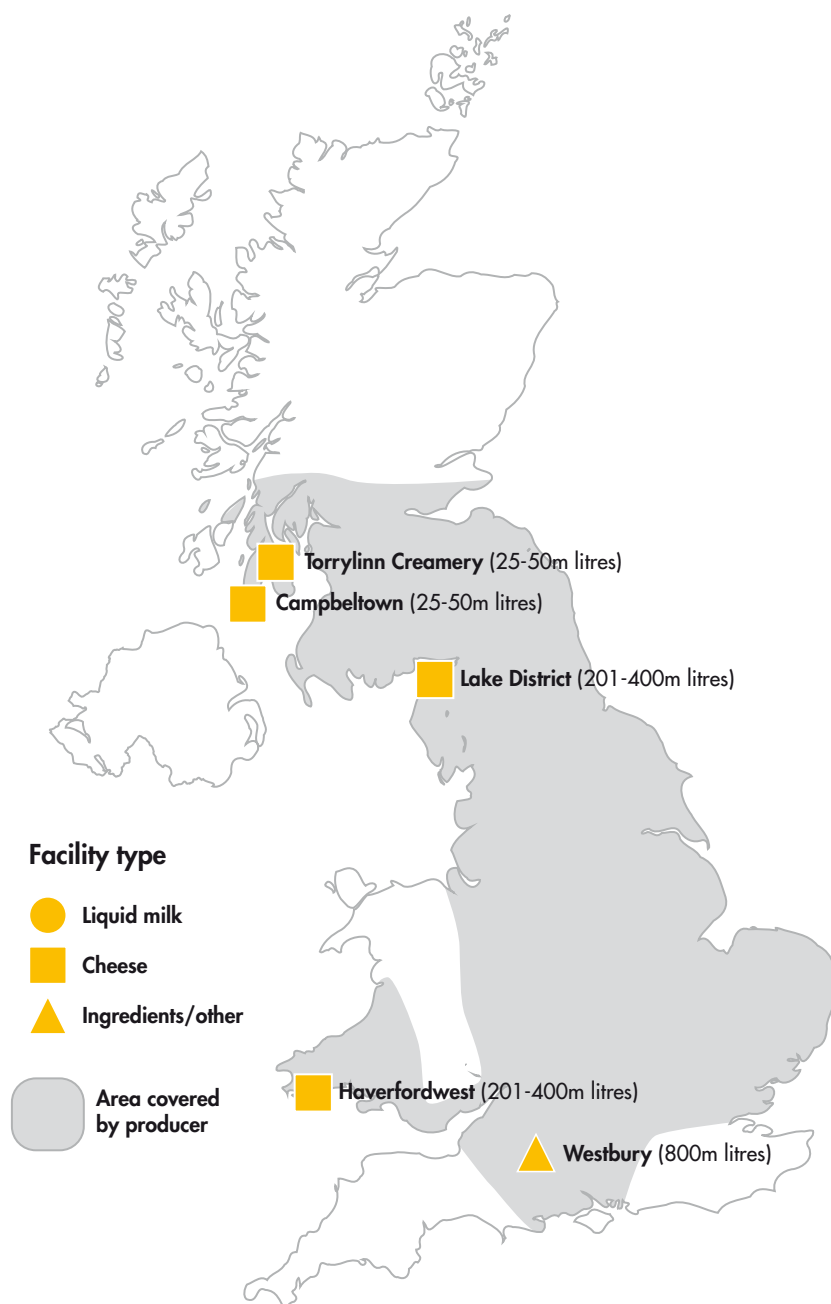
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Total milk purchases - 1,730m litres



There were no major changes in the utilisation of milk by First Milk between 2008/09 and 2009/10. The co-operative remains primarily a milk broker, with this accounting for approximately 60% of its milk supply, representing around 1bn litres. It is also a major cheese processor, with 28% of its milk supply directed towards the production of 39,000 tonnes of cheese in 2009/10. The remaining 12% of its milk was made into ingredients such as SMP and butter. From January 2010, all of First Milk's whey has been sold to the nutrition ingredients company Volac, which should provide a less volatile market for its whey and possibly higher returns.

D.



First Milk owns four creameries producing cheese and one factory processing ingredients, together with owning a share in the drying facility at Westbury. During the 2009/10 milk year, it closed the specialist dairy Ingredients facility at Maelor and the Isle of Bute creamery as part of its drive to increase efficiencies in the business.

Adding the capacity of its cheese factories, First Milk appears to have the capacity to process around 600m litres of milk into cheese. In 2009/10, it processed around 480m litres of raw milk into cheese suggesting that the factories are operating at around 74% of capacity.

In September 2010, First Milk and Milk Link agreed to a sale of a minority share of Westbury dairies to Arla. This has reduced First Milk's share from 66% to 59.3% while Arla own an 11% share.

Investments

£8.2m was invested in the 2009/10 financial year compared to £4.4m in the previous year. The investment was used to improve plants and facilities and for a new management information system. The deal with Arla, the closure of the Isle of Bute factory and the new Campbelltown factory where work will commence in 2011 are indications that the co-operative has done some rationalisation and is investing in its current processing facilities. First Milk has stated that it intends to keep a similar level of investment in the future.

D.

Markets

Liquid

First Milk is reliant on brokering milk to liquid processors who are in the process of increasing direct supplies, and this is therefore a shrinking market. Lately, there has been intense competition between the three main liquid milk processors to maintain market shares of retail sales, which is likely to have the effect of squeezing profit margins. This will probably impact on the price paid for brokered milk as processors will look to reduce costs. If full use of alternative markets is made by brokers however, the limited supplies available of brokered milk will counterbalance any drop in demand by liquid processors.

Cheese

First Milk primarily produces own label Cheddar cheese for the retail market. The own-label segment of the Cheddar market has grown by 6.1% in value terms and 9.5% in volume terms in the year ending December 2010²². Over the same period, branded Cheddars have performed better, with an 8.4% increase in the value of the market and a 7.7% increase in volume sales. The largest losers in this market were the 'value' own-label products which saw a 7.9% decrease in volumes and a 9.2% fall in the value of sales.

First Milk also owns the Lake District, Pembrokeshire, Mull of Kintyre, Isle of Arran and Scottish Pride brands. First Milk aims to push the Lake District brand into the top 3 UK Cheddar brands within the next three years. Kantar Worldpanel data show that between 2009 and 2010, the Lake District brand has more than doubled its sales in value terms and doubled its sales in volume terms. As a result, its market share has increased, although it would need to significantly increase volume sales to hit the number 3 spot. To grow the brand, a large investment in advertising and promotions would be required, which needs to be balanced against the gains in turnover and profits.

Ingredients

Commodity markets such as skimmed milk powder and butter have been strong since the end of 2009 and the outlook for the beginning of 2011 is good. First Milk is likely to have benefitted from good returns from this segment over the past 18 months. In the trading update, it has highlighted a significant increase in export sales of powders, and the development of new opportunities in China and Russia. The current context is therefore very favourable to First Milk for that market although this is a notoriously volatile market which could turn at some stage in the future.

²² Kantar Worldpanel data for the 52 week period ending 26 December 2010.

Highlights...

- First Milk is the main milk broker in the country, selling mainly to Robert Wiseman, Dairy Crest and Nestlé. With many processors looking to increase the amount of milk sourced directly, First Milk risk seeing this market shrink.
- In the cheese market, First Milk sell mainly own-label cheese. Its cheddar brands have shown solid growth over the past 12 months in both domestic and export markets.
- First Milk intends to keep its business model unchanged and to keep about the same split between its main markets: 60% brokered milk, 28% cheese and 12% ingredients.
- First Milk has the option to use Westbury to produce commodity ingredients mainly for balancing purposes but also as an alternative market. This can be used as a profitable alternative, but only when commodity markets are strong – returns are more volatile than in other markets.
- The sale of share of Westbury to Arla in 2010 should help to realise production efficiencies through enhanced utilisation.
- Investments totalling £8.2m is nearly twice as high as investment levels in 2008/09, although there will be no change to overall capacity as a result.

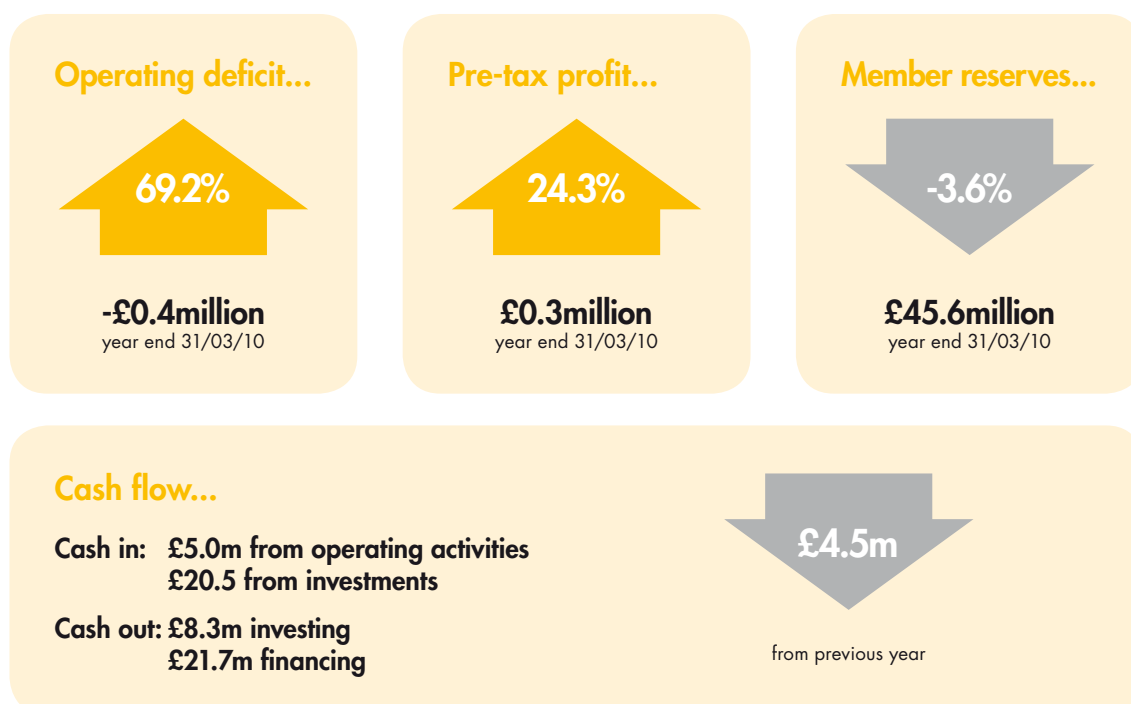
First Milk

Financial analysis.

D.

Headline figures

Headline financial figures and ratios have been calculated from the most recent full set of accounts for First Milk. Operating Profit figures do not include gains or losses from exceptional items. The definitions of the financial figures and ratios are available in the Appendix at the end of the report.



- The operating deficit (not including exceptional items) is smaller than last year as a result of a reduction in administrative expenses, but also due to the better alignment of milk prices to what the business could afford from its returns.
- The return on operations remains negative however which means more progress is needed for the business to become profitable.
- Turnover and cost of sales were lower than last year because of lower dairy product prices and milk prices and a reduction in volumes.
- The only segment which realised an operating profit was ingredients, which only accounted for 10% of total turnover.
- A pre-tax profit of £0.3m was the result of the sale of one-third of its shares in Robert Wiseman Dairies.
- First Milk made a loss for the second year in a row (-£1.2m) when pension costs are included.

D.

- This loss is lower than that recorded last year as a result of improved trading performance and the sale of a third of its Wiseman's shares.
- This loss has weakened the business's financial position.
- Equity fell for the second year in a row as a result of a fall in member's capital investment and decreased reserves.
- Equity will continue to fall if First Milk members continue to leave and if reserves are not rebuilt through better trading performances.
- First Milk has improved its net cash flow from operating activities compared to last year reversing a £5.1m loss to a £5.0m gain highlighting a better trading performance.
- Most of the cash earned from investments came from the sale of some Wiseman's shares worth £18.6m.
- With this cash, First Milk invested £8.2m into its business and repaid some long term and short term debt worth £16.9m and £4.8m respectively, although cash available is still down by £4.5m at the end of the year.

Financial ratios

Profitability ratios

Gross margin 3.5%

- Slightly improved trading performance on previous year (3.4%).
- This ratio remains very low indicating that the company is not as efficient at turning raw milk into income as other companies included in this report.

Pre-tax profit margin 0.1%

- Improved from -1.7% recorded last year due to sale of shares in Wiseman's Dairies.
- Taking into account pensions, First Milk record a negative ratio (-0.3%) which means that the company is making a small loss on the products it sells
- The loss is due to a lack of competitiveness in the market place.

Return on capital employed (ROCE) 0.3%

- Better than last year when ROCE was -7.8%
- Taking into account pensions, the ratio drops to -1.6%.
- The negative ratio is a sign of a lack of profits.

Debt ratios²³

Quick ratio 1.1

- No change from last year
- The ratio shows that FM has enough current assets to cover its current liabilities

Current ratio 2.4

- Increase of 0.2 from previous year
- The level of stock is higher than last year
- FM is liquid enough to cover short term liabilities

Gearing 60.7%

- 2.2 points lower than last year when gearing was 62.9%
- Gearing has improved thanks to a reduction in long term loans following the sale of Wiseman shares
- This remains high making FM very vulnerable to a fall in capital if some of its members leave

D.

Efficiency ratios

Debtor days 31.2

- 3.6 days lower than last year.
- First Milk managed to collect its debt quicker than last year on average.

Creditor days 26.4

- 1.5 days lower than last year.
- FM is paying its suppliers quicker than last year.
- This is a good ratio for FM as it pays its farmers quickly for their milk.

Stock days 50.3

- 5.4 days higher than last year.
- The level of cheese stock is higher than last year, which may be a result of increased cheese values.

The recent trading update shows improvements in the co-operatives financial performance, although a full set of results is not available. The six-month period was one of buoyant commodity markets and higher milk production which should have made the ingredients segment of the business very profitable as the milk price paid remained low, keeping costs of sales down.

The business will have to strike a difficult balance: on the one hand it needs to pay a high enough price to retain as many members as possible or runs the risk of losing volumes and available capital. First Milk have had the benefit of good trading conditions over the past 18 months which have helped to improve its financial position, which has in turn allowed it to lift milk prices to members. With the markets it operates in, First Milk will need to ensure it continues to pay a sustainable price and realise improvements in efficiencies.

²³ The revolving credit First Milk contracted is used to fund working capital (like cheese stocks) even though it is included in the long-term loan. This will alter the significance of gearing as gearing is only supposed to take into account long term loan. It will also alter the significance of the other 2 ratios as FM is likely to have more current liabilities than what is reported.

D.

Highlights...

- In 2009/10, First Milk paid the lowest price among the largest dairies and made a loss of £1.2m (when pensions are included), a weakening of its financial situation. This is due to the fact that the markets FM is involved with provide low returns and the company is not efficient enough yet.
- The sale of a third of its Wiseman's shares for £18.6m was a key feature in 2009/10 for First Milk, which allowed it to reduce net debt and report a lower loss than it would have otherwise.
- Despite its recent performance, First Milk has improved on the previous year: operating cash flow is up and the latest trading update for the first 6 months of 2010/11 would suggest that the financial situation has improved (although not all the figures have been published).
- The investment of £8.2m in production facilities should allow First Milk to gain production efficiencies, reducing costs, but is low compared to other dairy businesses.
- The business must balance the need to pay a high enough price to retain members but not too high to jeopardise its financial recovery.

Company profile.

D. Meadow Foods is a privately owned company with approximately 530 farmer suppliers. The principal activities of this company are the collection and marketing of milk. This is done through a significant brokering operation together with the manufacture and sale of a variety of dairy products to the food manufacturing sector.

The company states that it has a clear long-term strategy for growth. Its annual report states that working with the farming community, growing its milk field and continued investment in its processing facilities will allow it to offer its customer secure supplies in a dynamic and ever-changing market. As part of this strategy, it aims to add a new storage facility at its Chester plant, and has applied for planning permission for the development.

During the 2009/10 year, Meadow Foods acquired Nene Valley Foods in Peterborough from Dairy Farmers of Britain, which has allowed it to extend its range of products to include cultured products. As part of the acquisition, Meadow Foods moved its packaged cream business from Holm upon Spalding Moor, which resulted in the closure of its cream production line.

Competition for Meadow Foods varies across the markets it operates in. In terms of brokering liquid milk, Meadow Foods will be in competition with other liquid milk brokers, including the large co-operatives. In addition, Meadow Foods will need to be aware of existing milk buyers increasing the proportion of milk they buy from their own suppliers. With regards to others markets; it is likely that Meadow Foods could be competing with co-operatives such as First Milk and Milk Link for certain commodity products. In the ingredients market, where the main customers are food manufacturers, Meadow Foods will be competing with both domestic and non-UK manufacturers.

Current position

- Meadow Foods produces a wide range of products for the food manufacturing market and is significantly involved in the brokering of liquid milk.
- It offers a low milk price compared to other processors in its catchment area.
- It is involved in a large number of markets, providing the ability to switch markets to the best performing sectors.

D.

Future challenges and opportunities

- Commodity markets are currently strong with expectations that world supply is likely to fall short of demand during 2011, allowing Meadow Foods the opportunity to exploit the buoyant commodity markets.
- The company has very little long-term debt which could allow it take on long-term projects.
- There is a risk of a shrinking market for brokered milk as the larger milk buyers increase the proportion of milk bought from direct suppliers.
- Meadow Foods may need to address the relative position of its milk prices to ensure it maintains its supply base.

Procurement analysis.

D. Milk purchases

The table below gives details of Meadow Foods' milk supply base for the 2009/10 milk year.

	Direct supplies	Third party supplies	Total	Change from previous year
Million litres	430	150	580	no change
Numbers	525		525	+1.0%

There have not been any substantial changes in milk supply in the past year, with milk supply concentrated in deliveries by 525 direct farmer suppliers who account for just under 75% of the total milk handled. The remaining 150m litres is purchased from third parties or traded.

Recruitment

Meadow Foods, while not actively looking to increase producer numbers, will recruit replacement suppliers for those retiring, leaving production, or moving to alternative buyers. Factors important to the company when recruiting suppliers are the location of the farm (which needs to be in its current milk field), a level production profile, milk quality and the desire for the producer to enter into a long-term working relationship with Meadow Foods.

Contracts

The table below summarises the main features of the three variations on the supply contract currently offered by Meadow Foods.

	Contract 1	Contract 2	Contract 3
Name	Meadow Foods	Meadow Foods Level	Meadow Foods Lakes
Million litres	220		210
Producer numbers	265		260
End use	Food manufacture		
Catchment area	Shropshire, Cheshire, Staffordshire, Derbyshire, Lancashire & N. Wales		Cumbria
2009/10 average price (DairyCo standard litre)	23.14ppl	23.29ppl	n/a
Price changes Apr-10 to Feb-11	2 (+2.0ppl)		
Reasons for price changes	Market returns		

Figures relate to the milk year 2009/10

The Meadow Foods contract is essentially one basic contract with variations based on the seasonality structure. Farmer suppliers are offered a choice of standard seasonal payments or a profile scheme.

The Meadow Foods Lakes contract offers a slightly different payment schedule, which involves a profile payment rather than traditional seasonality. The contract was maintained when Meadow Foods acquired the milk field from West Lakes Dairy.

Bonuses are paid on volumes, but are staggered as collection volume increases. For example at lower volumes, bonuses are every 500 litres while at higher volumes, bonuses are at 2,500 litre increments.

Meadow Foods do not highlight limits on delivery volumes, although farmers producing less than 1,000 litres per collection are charged a penalty.

Price review

Price reviews are instigated by Meadow Foods, with the base level of the farmgate price determined by market returns. There is no negotiation process for price reviews, although Meadow Food state it takes producers' views regarding market conditions into account.

Commodity markets recovered in the second half of the 2009/10 milk year, and have remained strong throughout 2010. In July 2010, Meadow Foods announced a price increase of 1.0ppl, which only partially offsets the cuts of the previous year. This is despite the value of AMPE²⁴ rising by more than 10ppl between July 2009 and July 2010. A further 1.0ppl increase has been announced which will take effect from 1 February 2011.

Exit policy

Both the purchaser and the seller must give 12 months notice to quit the contract. There are quarterly exit points for suppliers, which can increase the notice period to 15 months.

Highlights...

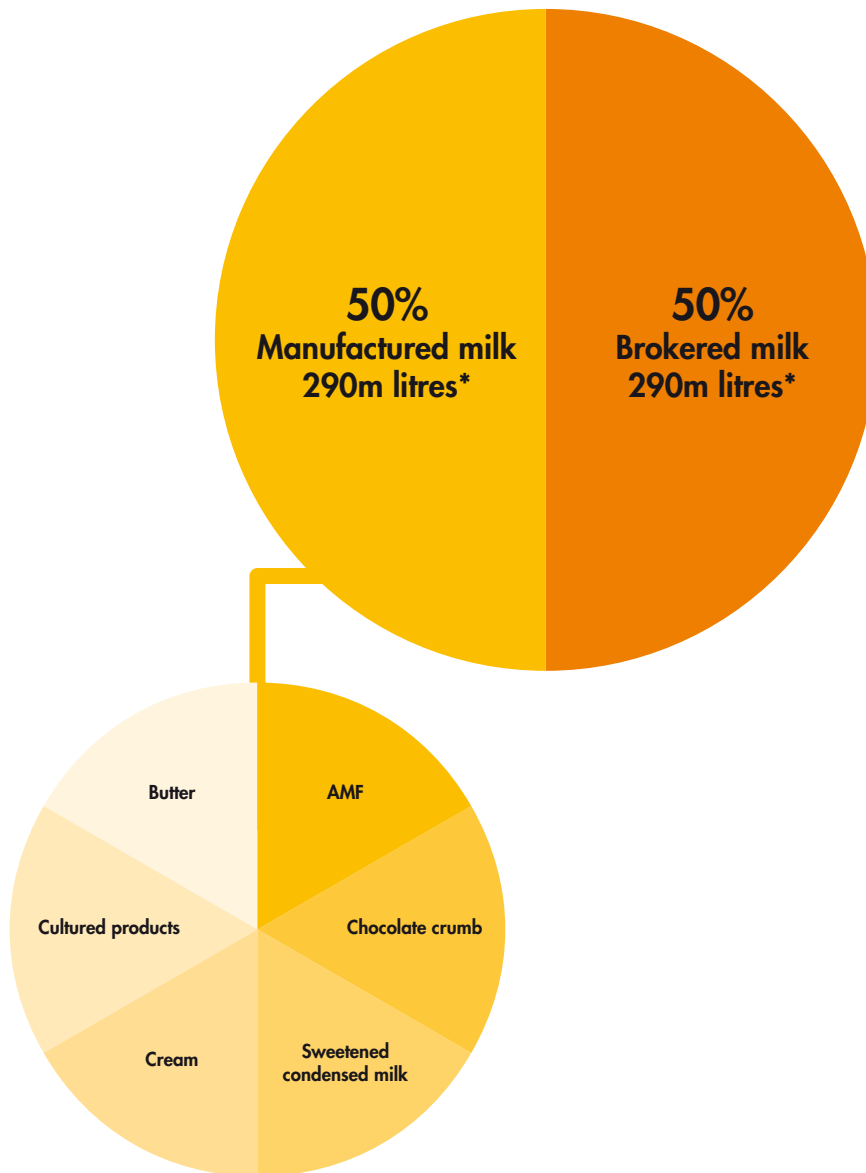
- Farmgate milk prices paid to Meadow Foods suppliers remain low, falling further down the DairyCo league table through the year.
- Willing to accept new suppliers to replace those retiring or leaving. No apparent restrictions on expansion from current suppliers.

²⁴ AMPE (Actual Milk Price Equivalent) is the DairyCo Datum market indicator which measures returns available from selling milk to commodity markets.

Production analysis.

D. Product portfolio

Total milk purchases - 580m litres



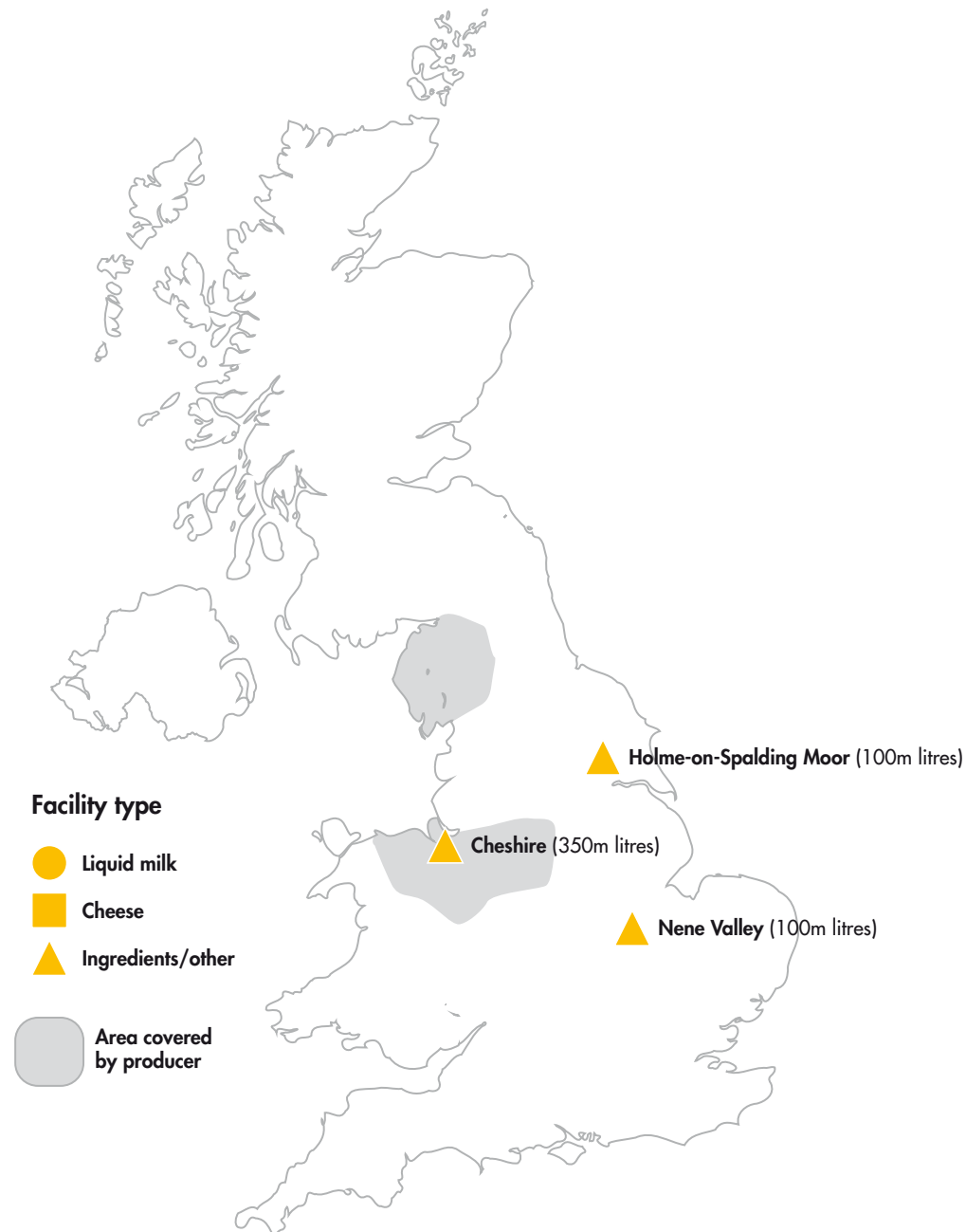
*Source: Dairy Crest estimate in September 2010 analyst's report (<http://investor.dairycrest.co.uk/presentations>)

Meadow Foods is primarily engaged in the production of dairy products for the food manufacturing sector. In terms of changes to its product portfolio, the 2009/10 financial saw the acquisition of Nene Valley Foods in May 2009 which allowed Meadow Foods to expand its portfolio into cultured dairy products.

Meadow Foods produces a range of dairy products, including both fresh and sweetened dairy products, utilising the cream from its own milk and the volumes

purchased from other dairies. The majority of the dairy products are used as ingredients in the manufacture of foods such as ice-cream, soups, sauces, ready meals, bakery and confectionery. The remaining milk is used to produce skimmed concentrates or balanced by supplying cheese producers and other third parties.

Production facilities



Meadow Foods has three main production facilities as shown on the map above:

The Holme on Spalding Moor site is primarily involved in the production of chocolate crumb and sweetened condensed milk. It produces more than 10,000 tonnes of each product per annum.

Nene Valley was purchased in May 2009 and has the capacity to process over 25,000 tonnes of packaged cream, in addition to other products such as sour cream and cultured ingredients.

D.

The Chester facility focuses on the production of Anhydrous Milk Fat (AMF) and cultured dairy products.

Meadow Foods currently has the capacity to process approximately 550m litres among its three facilities, and it is reasonable to suggest that since approximately half of its milk purchases are sold to third parties or brokered, it is not operating at full capacity. While this may impact on costs of production, it does offer sufficient capacity to expand its operations should the need arise.

Investments

In addition to the acquisition of Nene Valley, Meadow Foods has announced that subject to planning permission, it intends to add a new storage facility at its Chester plant.

There are no other announcements of further investments although as part of its long-term strategy it does suggest, “...continued investment in its processing facilities”. It could be assumed that with this new investment, production capacity could increase allowing Meadow Foods to broker less milk.

Markets

Meadow Foods does not produce any retailer products, concentrating solely on the food manufacturing sector. For example, Anhydrous Milk Fat (AMF) is used extensively in the yellow fats market, particularly for spreadable butter and ice cream. Retail figures suggest that the spreadable butter market has seen growth, and the ice-cream market continues to perform strongly.

Other ingredients produced include chocolate crumb, which is used in the production of milk chocolate and other chocolate based products; sweetened condensed dairy products, used for the manufacture of confectionary; and cultured products used in the manufacture of yogurts, fromage frais and as ingredients in ready meals. With the rise in consumption of ready meals, and the growth in yogurt markets, the company is operating in a growing market.

Highlights...

- There is no indication of the relative importance of any one product or market segment to Meadow Foods’ product portfolio, or the proportion of milk which is directed to added-value markets as opposed to brokering.
- Meadow Foods is operating in growing markets, including yogurts, ready meals, ice-cream and spreadable butters.
- The proposed investment at Chester could increase production capacity and may reduce the amount of milk brokered.

Meadow Foods

Financial analysis.

D.

Headline figures

Headline financial figures and ratios have been calculated from the most recent full set of accounts for Meadow Foods Limited. Operating Profit figures do not include gains or losses from exceptional items. The definitions of the financial figures and ratios are available in the Appendix at the end of the report.

Operating profit...

39.0%

£6.5million
year end 31/03/10

Pre-tax profit...

32.3%

£5.5million
year end 31/03/10

Total equity...

15.2%

£13.0million
year end 31/03/10

Cash flow...

Cash in: £11.1m

Cash out: £8.8m investing
£2.4m financing

£0.1m

from previous year

- Operating profit was up by £1.8m compared to the previous year (£4.7m), although this was reduced by £0.8m of exceptional costs, giving a net increase of £1.0m.
- Turnover increased by £16.4m (6.6%) compared to the previous year while cost of sales increased by £13.6m (6.2%).
- Increased turnover driven primarily from provision of fresh and cultured products in its Nene Valley facility.
- Increase in cost of sales is likely to be on account of increased distribution and/or production costs as milk price paid reduced through the course of the year.
- Pre-tax profits increased by £1.3m compared to the previous year.
- Dividends paid to shareholders totalled £2.2m for the year compared to £2.0m in the previous year.

D.

- Retained profit of £1.7m is £764k (81%) more than the previous year
– possibility of available funding for investment projects.
- Increase in equity on account of increase in retained earnings from £9.0m to £10.8m.
- Potential fund for further expansion.
- Minor change of cash in bank, down by £100K, primarily due to large amount of investment
- Reduced cash at bank from investment although very little debt within the business.

Financial ratios

Profitability ratios

Gross margin 11.5%

- Gross margin increased from 11.2% in previous year.
- Comparable to most other companies operating in similar markets.
- Involvement in lower valued products will impact margin.

Pre-tax profit margin 2.1%

- Net margin up compared to the previous year (1.7%) as lower finance costs contributed to higher net profit.
- Ratio is slightly lower than many of other companies examined, although comparable to other ingredients manufacturers.
- Not an issue as very little debt to service.

Return on capital employed 48.9%

- Return has increased compared to the previous year (38.1%).
- Ratio is high compared to industry average, due to low levels of long term debt.
- Increased operating profits have improved capital employed.

Debt ratios

Quick ratio 0.86

- Ratio has increased slightly compared to the previous year.
- This is in line with averages across the dairy industry.

Current ratio 1.01

- Virtually identical to the previous year.
- Roughly similar to the quick ratio showing that Meadow Foods has little in the way of stocks.
- Company has sufficient liquid assets to cover short term debt obligations.

Gearing 3.3%

- Very low gearing ratio due to very low levels of long term debt with good equity.
- Indicates capability to fund longer term projects.

Efficiency ratios

Debtor days 37.1

- Debtor days unchanged from previous year.
- Ratio is comparable to industry averages.

Creditor days 39.3

- Up from 38.4 in the previous year.
- Is higher than debtor days so is not impairing liquidity by paying creditors faster than receiving funds.

Stock days 7.9

- Stock days are down from the previous year (10.5 days).
- Short number of days falls in line with Meadow Foods' operations - fresh milk products and ingredients.

D.

Highlights...

- With the recent upward movement in commodity prices on world markets, Meadow Foods should have seen an upturn in market returns.
- Meadow Foods is a profitable business with good return on capital.
- Higher debtor days when compared to other companies.
- Very little long term debt which provides a good base for any future expansion if desired.

D.

Company profile.

D. Milk Link is a farmer owned co-operative with approximately 1,400 members and 600 direct supply farmers in 2009/10. Its main activity is the processing of milk into cheese, long life and flavoured milks, butter and other ingredients and the brokering of milk to third party processors.

According to its annual report, Milk Link's vision is to build the UK's leading added-value dairy products business. One of the phrases used by the company is, "adding value efficiently"; Milk Link is looking to run and develop a business which adds value to its milk which obtains the best return from the market for its members while doing so in an efficient, cost-effective manner. Milk Link aims to be the number one or two player in any of the markets it is involved with.

Milk Link has grown steadily over the last few years, and since the start of 2009/10 it has made several acquisitions including the purchase of Llandyrnog Creamery from Dairy Farmers of Britain (DFoB) for Cheddar production and Cornish Country Larder, a soft cheese business. Milk Link has also entered into a joint venture with Volac, the international ingredients firm, to develop a new added value whey processing facility at its Taw Valley Creamery.

Milk Link has streamlined its long life and flavoured liquid business with the transfer of operations from its Kirkcudbright dairy to Crediton. As a result, the Crediton Dairy now produces all of Milk Links liquid milk products.

In terms of competition, Milk Link competes with a variety of companies. Firstly, in the long life and flavoured milk markets, the company faces competition from Arla, Dairy Crest and European imports. In the cheese market, Milk Link produces both branded and non-branded cheese, facing competition from other large non-branded cheese producers such as First Milk and Adams (Irish Dairy Board), and from major Cheddar brands. The ingredients market is much more commodity based, with competition from both domestic suppliers such as First Milk and Meadow Foods, and from suppliers from other major exporters to the world market. In relation to the supply of raw milk, Milk Link has established long term relationships with some of the liquid milk processors such as Robert Wiseman Dairies and Arla, as well as other fresh dairy and food processors such as Cadbury's, Andros and Rodda. However, the majority of liquid processors are aiming to increase the proportion of milk supplied from directly contracted farmers, which will reduce demand for brokered milk.

Current position

- Recent acquisitions and investments in facilities should help to provide the base for efficient production.
- The Taw Valley Innovation Centre gives Milk Link the potential to develop new products and packaging to provide differentiation in the market place.
- Produces some products under licence agreements, which gives access to established brands.
- Wide mix of products allowing it to align production to the most profitable markets.
- Operates in the highly competitive cheese market.
- Has a diverse and growing customer base, trading with major retailers, food manufacturers and food service organisations.

D.

Future challenges and opportunities

- Needs to make full use of Taw Valley Innovation Centre and develop and refine products to take advantage of changing consumer preferences.
- Recent acquisition of Cornish Cheese Larder gives the opportunity of entering the soft cheese market giving further potential to increase returns.
- Large involvement in cheese market, parts of which are currently being devalued due to large number of branded Cheddar promotional sales.
- Joint venture with Volac gives Milk Link entry in potentially high value ingredient market.
- Aim to increase branded cheese sales in North American market, to take advantage of demand for British cheese.

Procurement analysis.

D. Milk purchases

The table below gives details of Milk Link's supply base for the 2009/10 milk year.

	Direct supplies		Third party supplies		Total	Change from previous year
	Members	Non-members	Co-operatives	Other brokers		
Million litres	1,245			195	1,440	+12%
Numbers	1,400	600			2,000	+25%

Milk Link increased the volume of milk it handled to 1,440m litres between 2009 and 2010, an increase of 160m litres. The increase resulted primarily from an increased number of suppliers, both members and those on direct supply contracts. The amount of milk purchased from third parties fell by around 100m litres, replaced by increased volumes from direct suppliers.

Recruitment

Milk Link has, in the current 2010/11 financial year, recruited around 200 new members. They currently have a substantial volume of milk (approximately 450m litres) enquiring to join, however Milk Link is currently restricting further recruitment to some specific geographical areas. Opportunities are limited as the co-operative is cautious about taking on full members unless there is a profitable outlet for the milk, as under the terms of membership, it is contractually committed on an evergreen basis to buy all of their Members' milk production, and does not want to find that it has to sell excess milk into unprofitable markets.

Contracts

	Contract 1	Contract 2	Contract 3	Contract 4	Contract 5	Contract 6
Name	Liquid	Manufacturing	Tuxford & Tebbutt	Northern Manufacturing Expansion	Cumbrian	Llandyrnog
Million litres	1,440					
Producer numbers	2,000					
End use	Liquid	Cheese & ingredients	Cheese	Cheese & ingredients	Cheese	Cheese
Catchment area	Southern England	National	Melton Mowbray	Scotland, N. England	Cumbria	Llandyrnog area
2009/10 average price (DairyCo standard litre)	23.52	22.92*	25.42**	22.87*	24.06	22.84***
Price changes since Apr-10	4 total +2.53ppl	4 total +2.75ppl	unavailable	4 total +2.45ppl	9 total +1.605ppl	3 total +1.50ppl
Reasons for price changes	Market returns and co-operative profitability					

*Average of A&B and Seasonal profiles. ** based on three month average from Apr-Jun 2009.. ***10-month average from June 2009
Figures relate to the milk year 2009/10

Milk Link offer six different pricing schedules, based on the end use of the milk and geographical locations. The majority of the pricing schedules are for milk used for cheese, with two limited to producers in specific locations. The Cumbrian 'direct' contract was established as a means to sign up non-member direct suppliers in Cumbria to source milk for its Lockerbie and Kirkcudbright factories. It remains available only to suppliers in that region. The Llandyrnog 'direct' contract is offered to farmers supplying milk to the Llandyrnog factory, most of whom are likely to have been ex-Dairy Farmer's of Britain members.

There are two member schedules which purchase milk for manufacturing, one for suppliers in Scotland and the North of England, and the other which covers the rest of the country. The milk supplied under these contracts is used in the manufacture of cheese and ingredients, and based on the DairyCo standard litre, received a lower average price than other pricing schedules for the period under review.

The Tuxford & Tebbutt 'direct' contract is specific to the Melton Mowbray area and is for milk used in the production of Stilton cheese. Finally, there is one member pricing schedule specific to milk used for the liquid market, which is limited to producers in Southern England.

All Milk Link member suppliers were required to pay a 0.5ppl contribution to the co-operative which is used to raise capital for investment. From 1 April 2011, this contribution will no longer be required for existing members, although new members will be subject to it for a minimum three year period.

In return for their loan capital, members receive a Processing Interest Payment which is set annually based on profits. In the 2009/10 financial year, this payment amounted to £3.3

D.

million, representing an 8.1% return on members' qualifying loans, equivalent to 0.35ppl. In the first half of the current financial year, Milk Link has again accrued a Processing Interest Payment equivalent to a return on Members' Qualifying Loans of just over 8%.

Price review

D. Farmgate milk prices are set by the Milk Link Board, which is comprised of Executive, Non-Executive and Farmer Elected Directors, of which the latter are in the majority. Price changes are primarily based on market returns and the profitability of the co-operative. Suppliers are given one months notice of an agreed price.

Since the end of the 2009/10 financial year, Milk Link members have received four price increases, announced in May, July, and August 2010, and February 2011. In total, the milk price increased by 2.75ppl for producers supplying milk for manufacturing, 2.53ppl for liquid suppliers and 2.45ppl for those on the Northern Expansion pricing schedule. From February 2011, prices paid on the liquid and manufacturing contracts are at the same level. These price increases have moved Milk Link up the league table and it was the first of the major buyers to increase milk prices in 2011.

Exit policy

As a co-operative, Milk Link offers an 'Evergreen' contract, meaning that it cannot give notice to a member. Members are required to give 12 months notice if they want to leave.

Supplier benefits

Milk Link offers farmer services through its Member website and engages with outside agencies to offer members support. Support is offered through technical advice pages, business data tools, monthly technical supplements, discussion groups, testing services and farmer workshops. Most recently, a series of workshops on Johne's disease were organised. Milk Link also has an in-house field team who visit farms to help with specific problems.

Highlights...

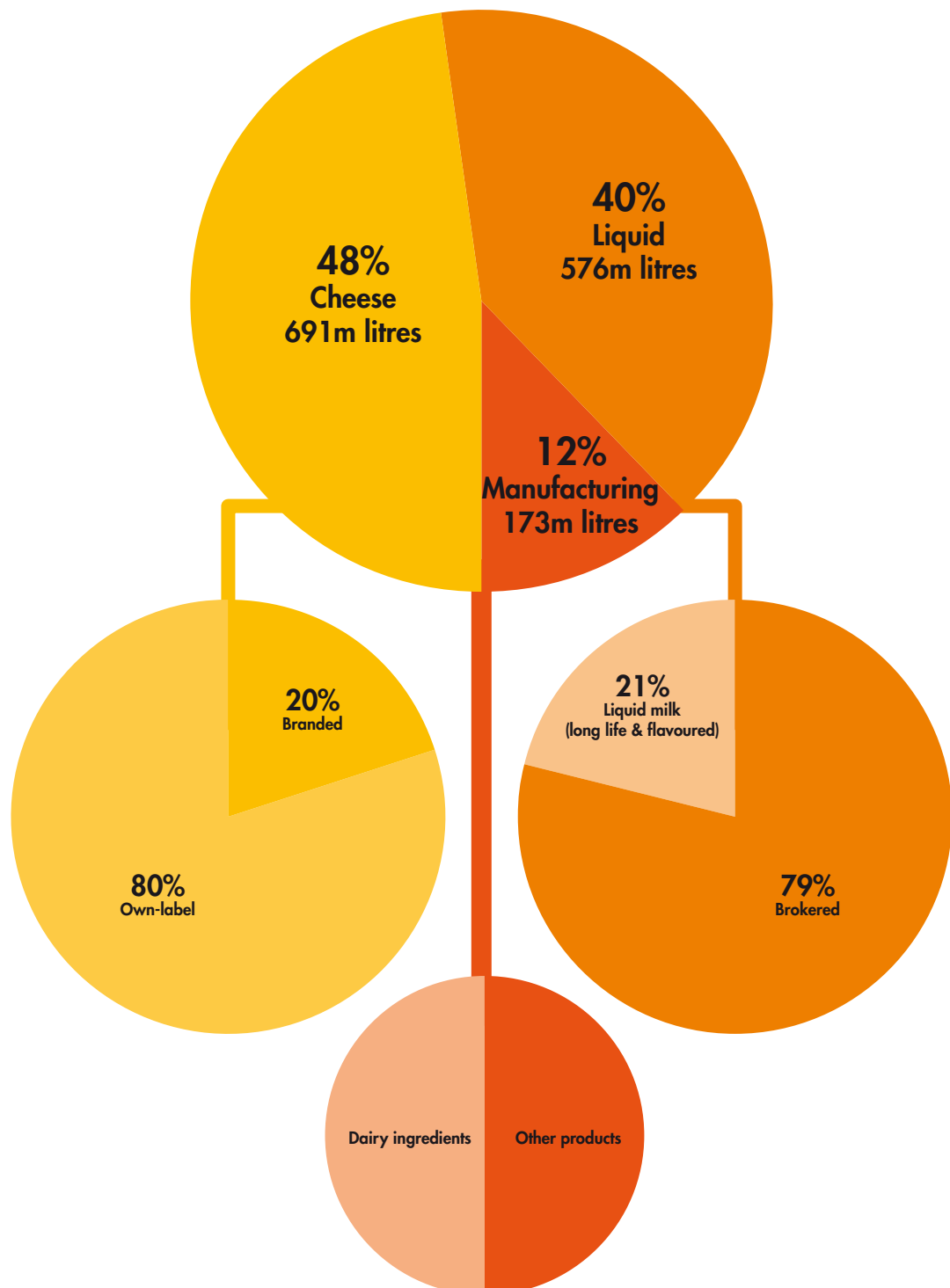
- In 2009/10 Milk Link's prices were in the lower half of the league table. However they have made several price increases and as a result have moved up the DairyCo milk price league table.
- Increased returns to farmer members from the removal of 0.5ppl levy, which also indicates the improved financial situation of the co-operative. An 8.1% return on member's loans was paid during the year.
- Milk Link publishes its price against the Defra farmgate price , which has tracked fairly well and expected to be above rolling farmgate price during 2011.
- Limited potential currently for joining as member, even for those currently on direct supply contracts.

Production analysis.

Product portfolio

D.

Total milk purchases - 1,440m litres



Based on product distribution from 2008/09 milk year

Milk Link is involved in the production of cheese, long life and flavoured milks, butter and other ingredients and the brokering of milk to third party processors. A small proportion of these products are sold as brands, with some of these under licence agreements. The majority of its cheese is sold as retailer own-label products, including 'named creamery' own label.

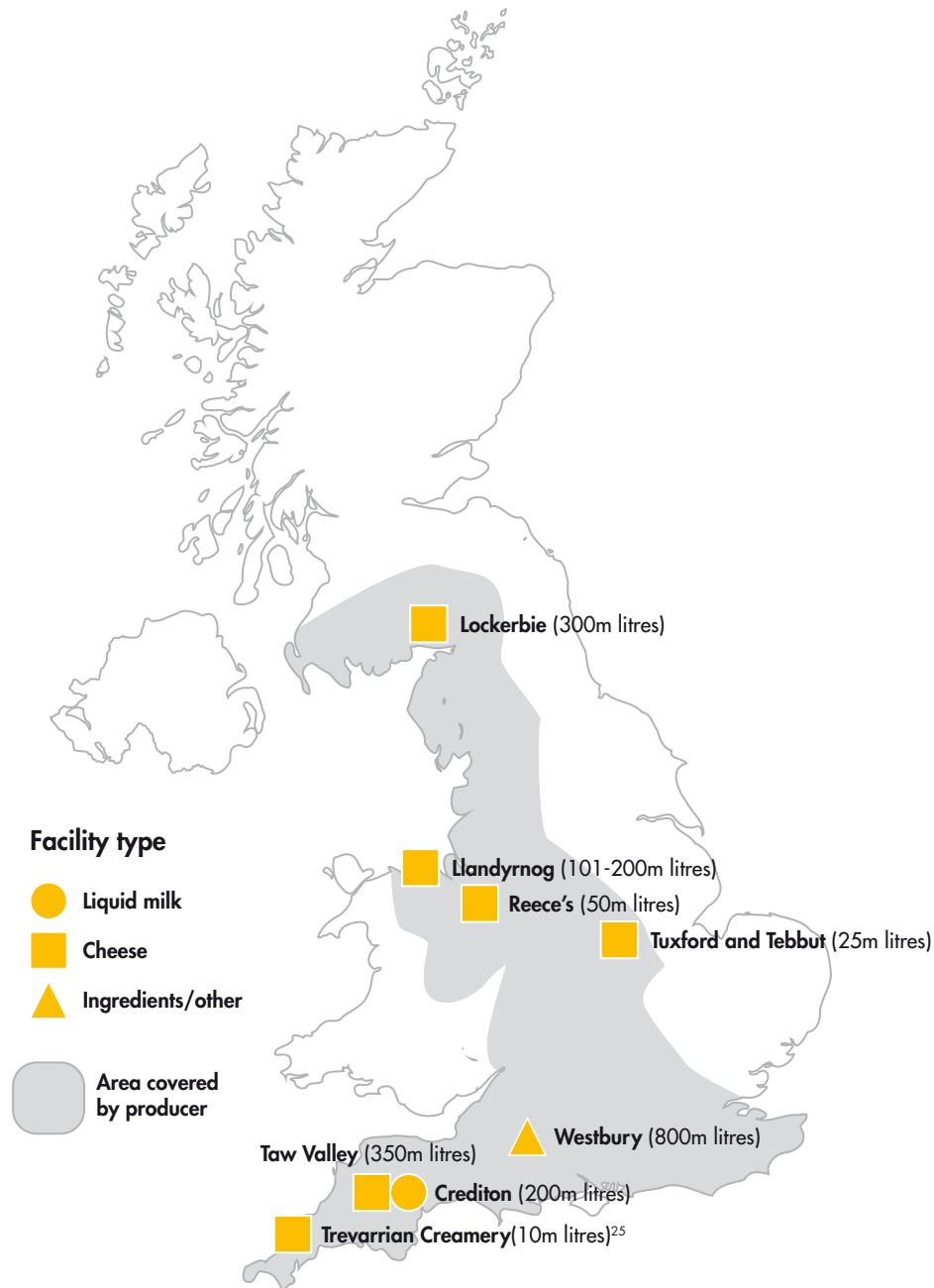
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In the liquid milk market, Milk Link's main activity is the brokering of milk, which accounts for approximately 30% of its total milk supply. The remainder of their involvement in the liquid milk market is in the production of long life and flavoured milk, sold both as retailer own-label, under the 'Moo' brand and under brand licences including 'Mars', 'Galaxy', 'Flora Pro active' and 'Charlie & Lola Pink Milk'.

Milk Link was the largest GB cheese manufacturer in 2009/10, producing over 70,000 tonnes of cheeses, including Cheddars, Blue Stilton and British regional and soft cheeses. These are supplied to the retail, food service and ingredients sectors in the UK and exported to over 25 countries internationally.

Milk Link also produces a range of branded dairy products for the food service industry under the brand 'Bladen'.

Production facilities



Milk Link operated six creameries in 2009/10²⁵ producing a range of cheeses, butter and long life and flavoured milk products. In addition, they have a cheese cutting and packing plant at Oswestry with the capacity to cut and pack 65,000 tonnes of cheese a year, and a part share in the facility at Westbury, which is used for butter and powder production.

Although not a processing facility, it is important to mention the Innovation Centre based at Milk Link's Taw Valley Creamery. The Centre was opened in September 2009 and has given Milk Link the opportunity to develop new products and to look at other areas such as packaging. An example of this has been the launch of the 'Grip-Strip', a new form of re-sealable cheese packaging. Currently, Milk Link only offers this with certain products in order to maintain a premium. They have also recently developed the lighter reduced fat '*I Can't Believe it's not*

²⁵ Milk Link purchased the Trevvarian Creamery in January 2011.

Cheddar' brand, which it has been producing under a licence from Unilever since early 2011.

Milk Link will look to continue to use its Innovation Centre to develop new products and packaging solutions which add value to existing products.

Investments

D.

In the current year, Milk Link have entered into a joint venture with Volac to develop a new added-value whey processing facility at Taw Valley. The £10m venture will give the co-operative the opportunity to further add value to whey and give it a presence in the nutritional ingredients market which, according to Datamonitor, is expected to grow to the value of \$3.6bn by 2013 on a European basis²⁶.

Milk Link has undertaken several cost saving initiatives during the year, including a £5m program of cost reductions in plant operations at Llandyrnog and the outsourcing of all its product distribution.

In January 2011, Milk Link acquired the Cornish Country Larder cheese business, providing it with the ability to further develop its range of cheeses, which will provide access to a wider market. Milk Link plans to develop the Trevarrian Creamery to enhance its processing capacity, product quality and service levels.

Markets

Milk Link has a good mix of customers throughout the supply chain, which gives the co-operative the option of moving milk into different markets as they become more or less profitable.

In the liquid milk market, its main product is long-life milk which is sold both as retailer own-label and under its 'Moo' brand. The long life segment of the milk market has seen a 4% decline in volume sales in the year ending March 2010²⁷ although the value of sales has remained steady. Total volume sales of the portfolio of 'Moo' branded products over the same period has remained unchanged, while the value of sales has increased by 10%. The positive performance is primarily the result of increased sales of 'Moo Organic', 'Moo 1%' and 'Moo' flavoured milks. Milk Link highlight that value growth has been achieved through measures such as the introduction of 'Charlie and Lola's Pink Milk', which is produced under licence from the BBC, and sells at a premium compared to 'Moo' Strawberry Milk.

Named creamery products²⁸ are becoming more important at the retail level, which although not a classical 'brand', do create a link to the creameries and are the first step in developing brand awareness. Milk Link highlight their agreements with Sainsbury's, Waitrose, Tesco, Marks & Spencers and the Co-operative which have seen a number of named creamery cheeses introduced. Enhanced product recognition allows Milk Link to differentiate from other suppliers and potentially generate higher returns for members.

Milk Link has a small but growing portfolio of branded cheeses, including 'Tickler' and

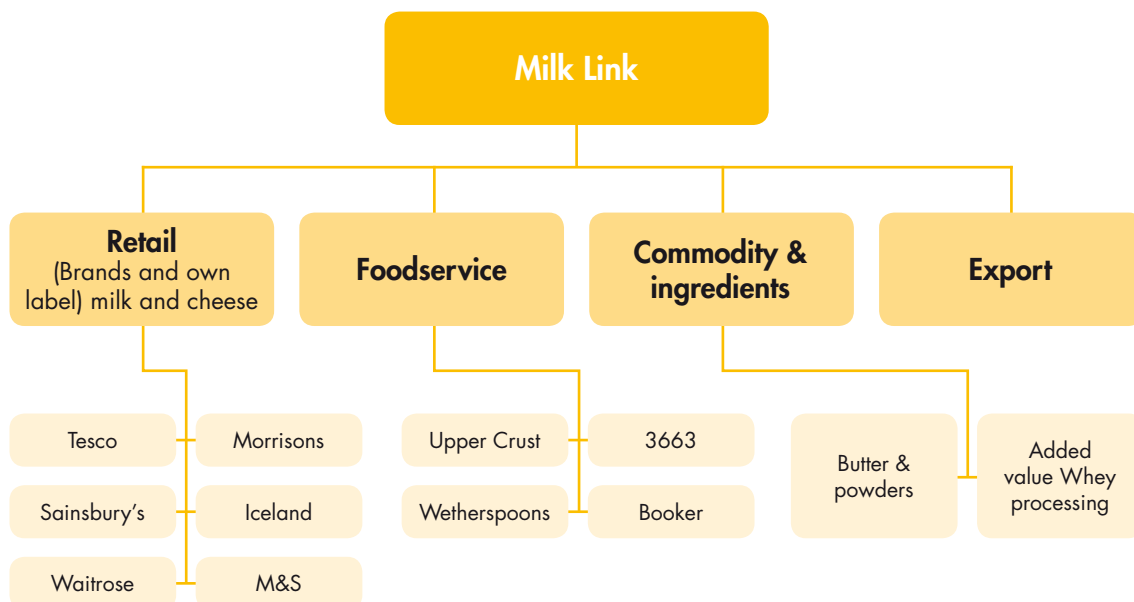
26 Nutra Ingredients.com. Sports nutrition market driven by non-sporty consumers (03-Jun-2010).

27 Kantar Worldpanel data for 52 weeks ending 21 March 2010 & 52 weeks ending 22 March 2009.

28 Creamery products are those where the location of the creamery is named on the package.

'I Can't Believe It's Not Cheddar'. Promotional support for the brands has resulted in growth in value sales for Tickler®, while the increased exposure for 'I Can't Believe It's Not Cheddar' should increase Milk Link's presence in the growing 'lighter' cheese category.

The figure below shows the breadth of Milk Links product portfolio and while there is no indication of the volumes directed to any one market, gives an idea of its ability to take advantage of the movements in markets to ensure it maximises returns for its members.



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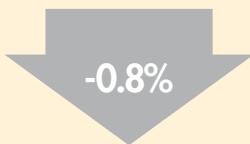
Financial analysis.

D.

Headline figures

Headline financial figures and ratios have been calculated from the most recent full set of accounts for Milk Link for the year ending 03 April 2010. Operating Profit figures do not include gains or losses from exceptional items. The definitions of the financial figures and ratios are available in the Appendix at the end of the report.

Operating profit...



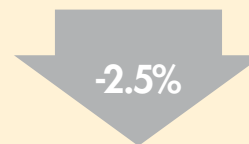
£19.6million
year end 03/04/10

Profit before tax...



£10.6million
year end 03/04/10

Total member reserves...



£59.4million
year end 03/04/10

Cash flow...

Cash in: £39.7m

Cash out: £33.5m investing
£12.3m financing



from previous year

- Operating profits (excluding exceptional items) were marginally down on previous year despite higher volumes.
- Cost of sales were higher, on increased volumes, but would be down by 10% on a per litre basis. This indicates an improvement in operational efficiencies.
- Revenues on a per litre basis declined by 11% from 42.57ppl to 38.1ppl, as a result of lower commodity prices and higher brokered milk volumes.
- The acquisition of Llandyrnog during the financial year contributed £25.2m to total turnover.
- After accounting for the exceptional costs related to the disposal of its Staplemead and Kirkcudbright factories, profits before tax increased by £1.3m (12.5%).
- On a pence per litre basis, there was no substantial change in profits before tax compared to the previous year figure of 0.78ppl.

- Finance costs were reduced during the year by 7% despite the purchase of Llandyrnog.
- Total Member Reserves fell compared to the previous year, although only by 2.5%.
- Decrease in Member Reserves was partly due to increase in pension liability of £9.8m, and partly to payments to resigned and retired members.
- Cash inflow from operating activities was up by 65.9% compared to 2009.
- Increase in net cash outflow due to £25.6m acquisition of Llandyrnog.
- Net debt increased by only £4.8m (6.3%) compared to the previous year despite the acquisition of Llandyrnog.
- Net cash outflow from financing was reduced from previous year, from £19.1m to £12.3m.

Financial Ratios

Profitability ratios

Gross margin 18.0%

- Slightly down on 2009 (18.5%).
- This ratio is at a comparable level to other businesses with a similar product mix.
- It needs to be read in conjunction with the improved milk price which has been paid.

Pre-tax profit margin 2.1%

- When excluding exceptional costs resulting from the closure of Kirkcudbright and sale of Staplemead, has increased slightly from 1.8% in the previous year.
- Including exceptional items, the pre-tax profit margin in 2009/10 was 1.8% and less than 0.1% in the previous year.

Return on capital employed (ROCE) 20.5%

- Return on capital has improved on previous year (2009 16.6%) and is now on par with industry averages.
- Suggests that efficiency programs and recent investments are proving successful.

D.

Debt ratios

Quick ratio 0.51

- Quick ratio is low and has reduced compared to the previous year (0.74).
- Milk Link's will have a higher level of assets held in the form of cheese, butter and powder stocks, reducing the quick ratio.
- Impacted by the age of debt held on the balance sheet, of which a significant proportion fell within short-term creditors category although has since been re-financed.

Current ratio 1.30

- Reduced from previous year (1.55) on account of £47m of bank debt falling within short term creditors.
- Despite reduction, does show that Milk Link can satisfy short term liabilities.

Gearing 38.0%

- Gearing is less than the previous year (48.8%).
- Lower because reduction in long term borrowing, commitments have now moved into current liabilities.
- Milk Link has recently gone through a refinancing of its borrowing facility.

Efficiency ratios

Debtor days 30.3

- Reduced by approximately 2 days compared to the previous year.
- Trade debtors reduced while turnover increased.
- Suggestion of tighter credit terms and improved cash collection.

Creditor days 52.0

- Virtually identical to the previous year (52.5).
- Due to large amounts of payments outstanding for milk purchases at year end, and high accruals balance.

Stock days 72.8

- Stock days have increased compared to the previous year (61.4 days).
- Increase due to increase in amount of milk going into cheese - particularly mature Cheddar.
- Impacted by large value of stocks obtained in Llandyrnog purchase and only part-year impact on costs.

Highlights...

- Improved performance from previous year despite difficult trading conditions.
- Cost reduction programmes have translated into a reduction in cost of sales per litre sold.
- Total Member Reserves in the business fell as a result of increased pension liabilities and payments to ex-members. However, Milk Link have a waiting list of new members, and the removal of 0.5ppl capital level for existing members from April 2011, is a positive indication that it has built up sufficient reserves for future investment requirements.
- Milk Link Board announced in its November 2010 Trading Update that the Member Contingent Liability Guarantee was to cease with immediate effect, indicating that the co-operative has achieved a sufficiently strong financial position with lenders.

D.

D.

Company profile.

D. Müller is a private company with its origins dating back to 1896 in Bavaria, Germany. In the 1970s and 1980s the company developed into a national and multinational brand. Müller entered the UK market in the late 1980s with the launch of 'Müller Corner'. It became the largest UK yogurt producer in 1992, following the construction of its Market Drayton dairy a year earlier. Müller Dairy (UK) Ltd is a fully owned subsidiary of the larger German business.

As part of the research for this report, Müller did not participate in an interview. Unlike the other companies researched, Müller also did not provide any information on its strategy, targets or performance. All of the information within this report has been accessed from published sources, such as company accounts, websites and press articles.

From what can be ascertained on its strategy from these sources, Müller aims to grow its business through continued growth in its existing markets, by accessing consumers who do not currently purchase Müller products, and by targeting the food service sector which it has neglected until recently. The business also aims to increase UK production from 95% to 100% of its total sales, displacing imports from Germany.

In terms of competition, yogurt and dairy desserts is a growing but competitive market and Müller faces competition from other well established brands such as Danone's 'Activia' and 'Actimel', and from own-label products. In addition, with the opening of Nom's yogurt production facility in 2009, there is now direct competition for its 'twin pot' style 'Corner' product.

Current position

- Market leader in Chilled Yoghurts and Pot Desserts category, with a very successful brand.
- Has maintained market share in 2010 although it is now facing increasing competition from Danone who saw a 13% increase in market share.
- Production facilities in Market Drayton are now 20 years old, although have been supplemented recently with a £12m investment in new machinery which will increase capacity to two billion pots per year.

D.

Future challenges and opportunities

- Operates in a market where penetration is high, so requires continuous investment in new products and packaging to grow consumer sales.
- There is a challenge to grow consumption levels in the UK to match those in Europe, where it is forecast to grow by 35% by 2012 compared to the projected 6% growth in the UK²⁹.
- Challenge to grow market share and to stay ahead of its main competitor Danone, who have grown through acquisitions and successful development of its 'Actimel' and 'Activia' brands.

Procurement analysis.

D. Milk purchases

The table below gives details of Müller's milk supply base for the 2009/10 milk year.

	Direct supplies		Third party supplies	Total	Change from previous year
	2008/09	2009/10*			
Million litres	205	215	25	240	4%
Numbers	150	150		150	no change

*estimated growth of current suppliers of 4% per annum

Müller's milk requirement is around 230m litres per annum with 90% sourced from directly contracted farms. The remaining balancing requirements are sourced locally from Robert Wiseman Dairies or Dairy Crest, with seasonal surplus milk sold on.

All of Müller's direct milk supplies are from farms within 30 miles of its Market Drayton factory. It is not believed to be actively recruiting and while the recent investment has increased the capacity of the facility, this is likely to simply utilise any increased deliveries from current contracted suppliers.

Contracts

	Contract 1
Million litres	215
Producer numbers	160
End use	Processing
Catchment area	30 mile radius of Market Drayton
2009/10 average price (DairyCo standard litre)	Unknown
Price changes Apr-10 to Feb-11	Unknown
Reasons for price changes	changes in input costs & returns from market

Müller does not include any seasonality payments in its contracts, but does offer incentive payments for butterfat and protein content.

Price review

There is no formal negotiation process in place to determine prices, and decisions to change farmgate prices are solely those of Müller. One month's notice is required when the price changes, although the company aim to give more notice where possible.

Exit policy

Müller launched a new contract in 2008, which offered different terms to the old contract. Producers on the old contract were on six months notice, which was retained, but the standard notice period for new producers is now 12 months. Müller are required to give 24 months notice, although these terms can be extended through negotiation.

Highlights...

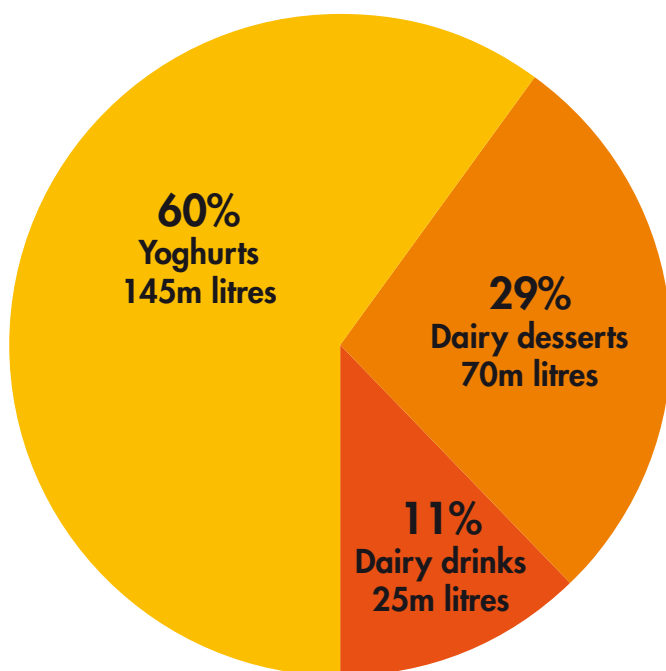
- Limited availability for new suppliers and these are likely to be restricted to the existing geographical catchment.
- Operates an A/B pricing system with payments on deliveries above base level paid at a different rate.

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Production analysis.

D. Product portfolio

Total milk purchases - 240m litres



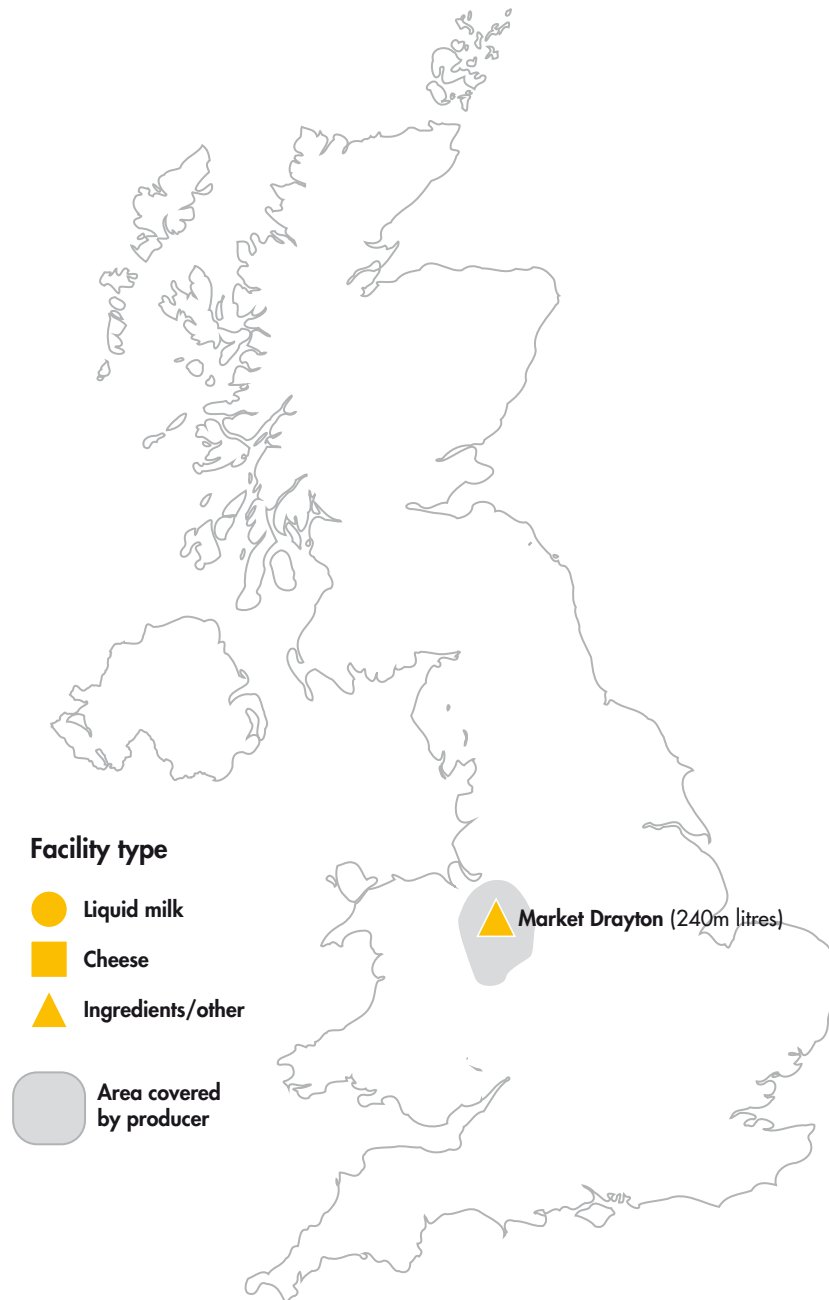
Müller is solely involved in producing branded yoghurts and dairy products for the retail market. As part of a foreign owned company, some of its branded products are imported although the milk purchased from GB farmers is solely used for products sold on the domestic market.

The company owns three main established brands in 'Müller Corner', 'Müller Light' and 'Müller Rice'. It has also launched supplementary products targeting the children's market ('Müller Little Star') and a probiotic yogurt drink in 'Müller Vitality'.

Looking forward Müller has identified three key usage occasions to target for increased yoghurt consumption: breakfast, lunchboxes and snacks³⁰. To develop this category it aims to develop products and pack formats to offer more usage occasions; to increase shelf space usage in retailers, to increase the range of products stocked in convenience stores and to promote the 'healthy' image of the products.

³⁰ DIN, Müller UK Category Report 2010.

Production facilities



Müller operate one facility in the UK located at Market Drayton in Shropshire. The site produces 95% of Müller's needs to service the UK market although the company aims to produce 100% without the need to import from Germany.

The facility is now 20 years old, although there have been extensions to the capacity of the dairy in 1999, 2001 and 2009. The most recent expansion in 2009 saw the site reach its full potential for increased capacity. Any further expansions will require a new development, which would likely be on the adjacent land which is owned by the company.

D.

Investments

Müller intends to invest £38m in marketing its brands during 2010, with the aim to promote the three main messages of yoghurt as a healthy product and its diversity for different meal and snack occasions.

D. Markets

The yoghurt market has enjoyed steady growth in recent years. In the year ending March 2010, the yogurt market grew by 4.0% in volume terms and 5.7% in value terms, according to data from Kantar Worldpanel. This growth was primarily driven by increases in branded products which saw volume sales increase by 6.9% compared to a 4.4% decline in sales of own-label yogurts.

Müller's portfolio held a 36% share of the market in 2010, which was unchanged from the previous year. Müller's main competitors in this market are Danone who saw an upturn of 15% in volume sales and 12% in value sales over the year. This translated into an increase in its market share from 16% to 18% of total volume sales.

The other product to see good growth over the period was retailer own-label 'twin pots', which more than doubled sales, although the own-label yogurt as a whole declined by 4.4% in volume terms.

Within the yoghurt drinks category Müller produces '*Vitality*', a probiotic drink. The category's value has declined by 18% while its market share in volume terms has reduced from 27% to 22%. While it remains a market leader in this category, it has seen Danone grow in relative importance along with own-label yoghurt drinks.

Highlights...

- Facing increasing pressure on 'Corners' market from own-label 'twin-pot' products and Nom.
- Has lost market share to Danone in yoghurt drinks but has maintained leading position.
- Will require new development to service any new growth and to maintain efficiency of the current facility.
- Current location has reached, or is close to, full capacity although there is potential to develop adjacent site.

Headline figures

Headline financial figures and ratios have been calculated from the most recent full set of accounts for Müller UK. Figures do not give a complete overview of the finances of the business as it appears that long-term debt and some assets may be held on the balance sheet of the parent company in Germany. Operating Profit figures do not include gains or losses from exceptional items. The definitions of the financial figures and ratios are available in the Appendix at the end of the report.

Operating profit...



£37.2million
year end 31/12/09

Profit before tax...



£36.9million
year end 31/12/09

Total equity...



£43.9million
year end 31/12/09

Cash flow...

Cash in: £41.4m from operating activities
£1.5m from investments

Cash out: £5.4m financing



from previous year

- The operating profit is more than double the previous year. However, taking into account large foreign exchange losses in 2008, the increase in operating profits was up 60.3% from £23.2m.
- There was very little change in total turnover but cost of sales fell by 7%, benefiting from *"improvements in buying prices from our supplier which has more than offset increases in raw material costs."*³¹
- After accounting for the foreign exchange losses in the previous year, pre-tax profits increased by 34%.
- Very little depreciation as it appears that fixed assets are held by parent company in Germany.

³¹ As quoted in Müller Dairy (UK) Limited, Directors' report and financial statements 31 December 2009.

- Equity has increased by the value of net profits which are retained on the balance sheet of the UK company.
- As no dividends were paid in 2010 from the UK company, there was a large increase in net cash for the year.
- Cash may have been held back for investment in brand growth.

D.

Financial ratios

Profitability ratios

Gross margin 31.2%

- Improved gross margin attributed to reduced costs of sales.
- The high value indicates that higher margins are obtained when turning raw milk into added value products and the company is efficient in doing this.

Pre-tax profit margin 9.2%

- Increase from 4.7% in previous year.
- Indicates that the company is making a good profit on the products it sells and is competitive in the market.

Return on capital employed (ROCE) 84.8%

- This ratio is very high in relation to other dairies, although is not truly reflective of the return on capital employed as no debt is held on the UK balance sheet.

Debt ratios

Quick ratio 1.5

- Ratio is marginally higher than last year but remains comfortable.
- Shows that Müller has sufficient liquidity to cover its short term credit commitments.

Current ratio 1.6

- Increase of 0.3 from previous year.
- Significantly higher cash at bank, with no substantial change in liabilities.

Gearing n/a

- As Müller hold no long term debt on the UK companies balance sheet, a gearing ratio cannot be calculated.

Efficiency ratios

Debtor days 39.4

- Has reduced debtor days by just under 9 days, which indicates, the company is now collecting debt within a similar timescale as the average across the industry.

Creditor days n/a

- As Müller does not hold any debt on its UK balance sheet, this ratio does not give an accurate representation of how quickly it pays its suppliers.

Stock days 6.4

- Turnover is fast as Müller is dealing with a short life dairy product.

Highlights...

- Müller report solid financial results; although it must be taken into account that a full account of the financial situation of its UK operations cannot be determined as it appears that its debt is held on the accounts of its parent company.

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D.

**Robert Wiseman
Dairies.**

Company Profile.

D. Robert Wiseman Dairies is a public limited company listed on the London Stock Exchange. It is the 5th largest buyer of milk in Britain³², with 950 direct suppliers who delivered in the region of 1.1 billion litres in the 2009/10 financial year. This equates to just under 10% of total British milk production. The company is solely involved in the procurement, processing and delivery of liquid milk, with approximately two-thirds sold to the major retailers, and the remainder to the middle market. It also produces a small amount of potted cream, although the majority of its excess cream is sold as bulk for export to the continent.

Wisemans has expanded rapidly over the past five years and now operates seven production facilities across the country. In September 2010, it completed the final phase of its Bridgewater facility in Somerset, bringing its processing capacity to 2 billion litres per annum.

The company issued a profits warning to its shareholders in September 2010 announcing an expected decrease of £7m in operating profits for the second half of the financial year due to intense pressure in the liquid milk market and highlighted a £16m potential reduction in earnings the following year. Its short term target is to improve margins through ongoing cost control, keeping in mind that one of its main costs is the cost of milk.

Long term, Wiseman's Dairies aims to increase the total amount of milk processed to 2 billion litres, whilst increasing the proportion supplied from contracted producers to 70% by the end of the 2011/12 milk year.

The company is facing increasing competition from other liquid milk processors (notably Dairy Crest and Arla) for retail contracts. With a large share of milk purchases on retailer aligned contracts, which attract a premium, it is becoming increasingly important for Wiseman's to maintain existing volumes.

Competition is also increasing in the middle market, as some of the medium sized dairies are growing, gaining size economies and becoming more competitive. With the collapse of Dairy Farmers of Britain, there was a period of redistribution and some of these dairies were able to recruit new direct suppliers. This has led to the current situation of excess capacity in the liquid market, and the liquid suppliers are currently competing with each other to gain or maintain market share in order to utilise the capacity.

32 Not including milk purchased from third parties.

Current position

- Holds a large share of the retailer own-label milk market but facing strong competition from Dairy Crest and Arla.
- With focus on retail markets, offers a milk price near the top of the DairyCo league table.
- Recruitment of more direct suppliers has led to an increase in its milk pool, which along with milk bought in from third parties has met increased sales volumes.
- It is heavily dependent on three large customers, which account for 64% of turnover.
- The company has a strong balance sheet with low levels of debt.
- Has invested in its dairies over a long period and now owns modern efficient dairies.

D.

Future challenges and opportunities

- Wiseman Dairies will need to maintain retail sales volumes at a sustainable price to ensure it can pay its suppliers enough to maintain its supply base.
- The development of its new production line for filtered milk will provide the opportunity to increase sales volumes of added-value product. The success of this venture will depend on Tesco's ability to compete with 'Cravendale' for sales of filtered milk.

Procurement analysis.

D. Milk purchases

The table below gives details of Robert Wiseman's Dairies milk supply base for the 2009/10 milk year.

	Direct supplies		Third party supplies		Total	Change from previous year
	Aligned	Non-aligned	Co-operatives	Other brokers		
Million litres	835	235	700		1,770	+9.0%
Numbers	715	235			950	+14.5%

Milk deliveries from direct suppliers were 8% higher in 2009/10 than in the previous financial year, when they totalled 992m litres. This is largely due to the increase in the number of direct suppliers in the Wiseman Milk Group, which increased during the financial year by 120 to reach 950.

Total volumes processed increased by just over 9%, leaving the percentage of milk supplied from direct suppliers for 2009/10 milk year at around 60%. With the additional recruitment which has occurred since the end of the last milk year, this is expected to increase the proportion to 65% by the end of the current milk year, against its stated aim to reach 70% direct supply by the end of 2011/12. If this is achieved, it would lead to an increase in direct supplies of around 200m litres.

Approximately 75% of milk purchased from third parties is sourced from First Milk with the remainder from Milk Link and OMSCO.

The size of the Tesco milk pool was slightly smaller than the previous year, with approximately 15 fewer suppliers. In addition, the lower sales volumes resulting from the redistribution of Tesco volumes between Wiseman Dairies and Arla, and the decrease in Tesco's milk sales meant that some of Tesco suppliers were paid the premium price on lower volumes. This may change in the current milk year, as Tesco has placed its requirements for its milk brands 'Creamfields' and 'Pure' within the dedicated milk pool as of December 2010. This is estimated to require an additional 50m litres from the Wiseman Group for the next year.

Recruitment

Wiseman Dairies have a near term target to increase total milk processed to 2 billion litres, which is a further 13% increase on its 2010 level. Recruitment is primarily focussed in the South West now that the Bridgwater dairy is fully operational. There are also some opportunities for suppliers in the Midlands and Scotland, although as stated in

the annual report, "... in order to ensure optimal efficiencies, Wiseman Milk Group member farms are likely to be close to our dairies" and are likely to be larger farms.

Recruitment factors include attitude to retailers, welfare, the environment, along with a preference for larger producers with a flat production profile to minimise transport and balancing costs. Wisemans are however willing to recruit seasonal or smaller suppliers so long as it can balance off with another farm in a current collection area.

There is also the opportunity for current suppliers to increase production as Wisemans are looking to increase the proportion of direct supply, although those on aligned contracts will not necessarily benefit from the premium milk price on excess production.

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Contracts

	Contract 1	Contract 2	Contract 3
Name	Wiseman Partnership	Sainsbury's	Tesco
Million litres	235	225	610
Producer numbers	250	200	500
End use	liquid	liquid	liquid
Catchment area	Contracts are not geographically specific		
2009/10 average price (DairyCo standard litre)	24.13	26.22	26.73
Price changes Apr-10 to Feb-11	2 +1.4ppl	2 +1.0ppl	3 +1.13ppl
Reasons for price changes	Returns from commodity prices and competitor pricing		Promar cost tracker

Figures relate to the milk year 2009/10

Wisemans offer three contracts, two of which are aligned to major retailers; Sainsbury's and Tesco. The Sainsbury's contract pays a premium of 2.1ppl to members of the Sainsbury's Dairy Development Group (SDDG) on the Wiseman Partnership non-aligned price but do not require that the milk supply is segregated throughout the supply chain. The number of dairy farmers on the Sainsbury's contract has not changed through the year, nor have the volumes supplied.

Producers supplying milk to Tesco are all members of the Tesco Sustainable Dairy Group (TSDG) and the milk supplies are segregated throughout the supply chain. Producers on the Tesco contract may be on either the 'core' contract or the 'seasonal' contract. 'Core' suppliers are paid the premium price for volumes utilised in Tesco milk sales, and the non-aligned price for any extra production, while for 'Seasonal' suppliers, the Tesco price is paid for the portion of milk deliveries which are sent to Tesco, although only when volumes from core suppliers is insufficient to meet Tesco needs.

Early in the 2009/10 financial year, Tesco realigned its supply contract, and Wiseman Dairies lost volumes reducing its share of Tesco's milk requirements from 60% to 50%. This meant that some producers on the Tesco aligned contract would have received the premium price on lower volumes. The number of producers fell from 515 to 500 during this time,

D.

although expansion of these producers meant that volumes increased by 6% (575m to 610m). A further realignment of the Tesco supply contract in November 2010 meant Wisemans regained some volumes, bringing its share of the own-label milk back up to 55%.

From December 2010, all milk supplied to Tesco, excluding organic, has been on the TDSG contract which has increased volumes paid the aligned price, although this will only impact producers who are already on these contracts. The move was initiated by Tesco as a way of dealing with the expansion of TSDG members, but as total sales volumes to Tesco will now include 'Pure' filtered milk and 'Creamfields' low fat milk, both of which are in growing market segments, the move offers the potential for further expansion for current members.

With such a large proportion of its milk pool aligned to retailers, the benefits to farmers of expanding production are reduced if sales to the retailer do not grow at the same rate, as extra milk production will not be paid at the higher rate. Growth or decline in retail sales will also impact farmers' incomes for those on aligned contracts, as changes in retail sales volumes will impact the total volumes paid the premium price.

Price review

The price paid for milk supplied by members of the Wiseman Partnership who are not on aligned contracts is set by Wiseman Dairies, based on market conditions and at a level to ensure it is competitive in the market place. There is no pre-defined formula, but the company aims to ensure that it is at a level which will ensure sufficient supply.

Historically, the Wiseman non-aligned price has been near the top of the DairyCo league table, although this changed during the latter half of 2010. Since the end of the 2010 financial year, there has been only one change in the Wiseman Partnership price, which was an increase of 0.4ppl in July, following sustained increases in commodity prices. A further price increase of 1.0ppl was announced in January 2011 but will not take effect until 1 March 2011.

Producers on the Sainsbury's contract also received the 0.4ppl increase in July 2010. From December 2010, an additional bonus of 0.6ppl, called the 'Winter Premium', was implemented to take account of rising feed costs. The bonus is likely to be temporary, and given on the condition that any price increases from processors will be absorbed into the 0.6ppl. This means that from 1 March, the producers on this contract will in effect only receive an additional 0.4ppl.

Prices for milk supplied on the Tesco aligned contract are set based on costs of production and market conditions. A six-monthly price review is performed based on Promar costings, which along with current market conditions, sets the milk price for the next 6 months. Producers who are signed up to provide Promar with cost of production figures get an additional 0.5ppl on top of the Tesco aligned price. The Tesco price was adjusted down in April 2010 by 0.47ppl but then increased in October 2010 by 1.28ppl. As with Sainsbury's, Tesco announced a special adjustment to its price to account for the rising costs of feed which increased the price by 0.32ppl, effective February 2011.

Exit policy

Contract notice is 3 months, although suppliers cannot serve notice during July or

August due to the impact on volumes during the seasonal production trough.

Highlights...

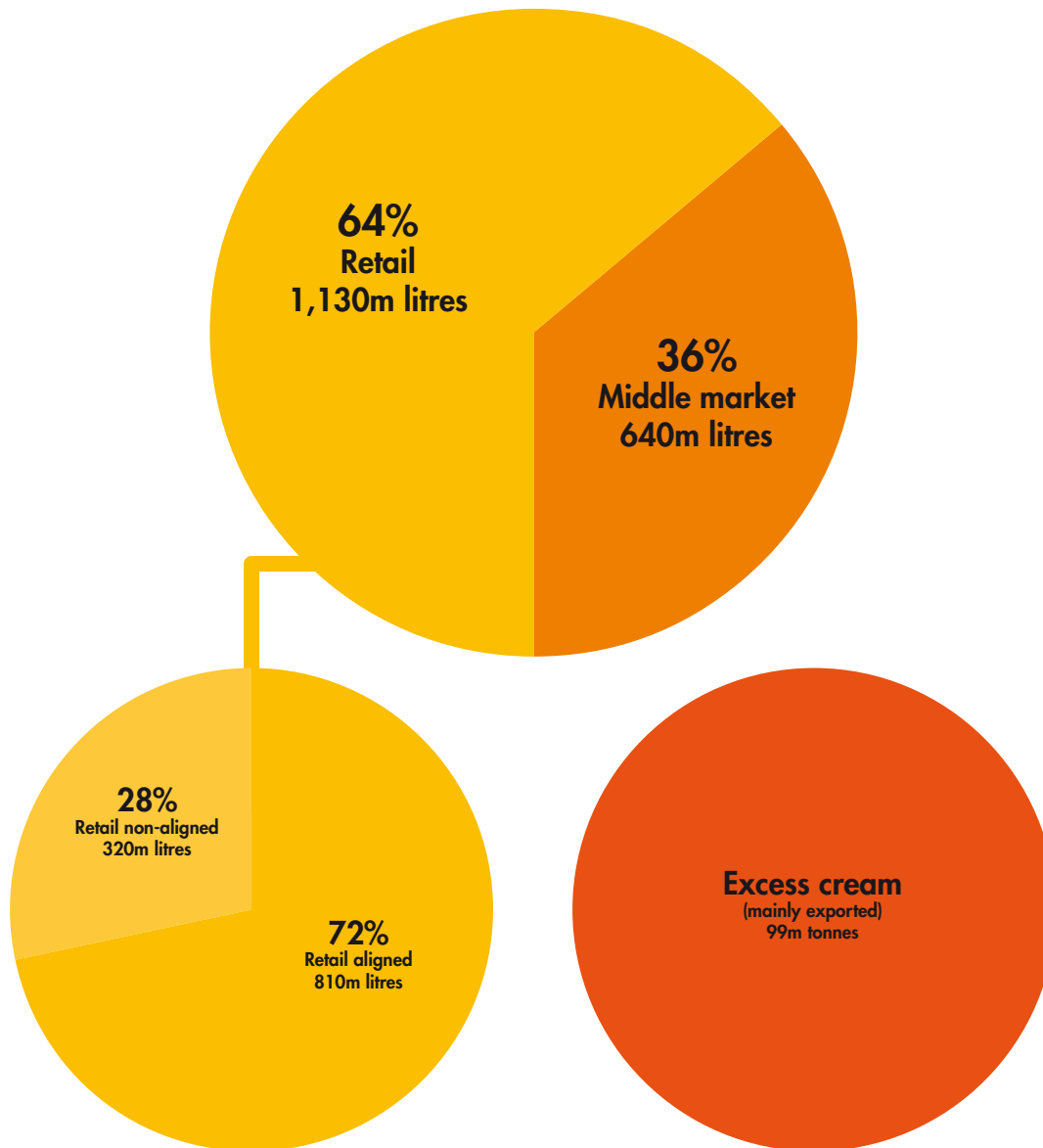
- Aim to expand total milk processed to 2bn litres and the proportion of milk purchases from direct suppliers to 70% which will create opportunities for current and potential suppliers.
- Non-aligned liquid milk prices became less competitive during 2010 as it did not respond to improvements in market returns.
- While commodity prices for cream remained high, increased returns were used to subsidise other input costs which were rising (i.e. plastics, oil).

D.

Production analysis.

D. Product portfolio

Total milk purchases - 1,770m litres



Wiseman Dairies produced approximately one third of the milk consumed in UK in 2009/10, serving the major retailers and the middle market. The dairy primarily produces own-label milk for retailers, although it also sells under the Robert Wiseman 'brands' of 'freshnlo', 'The One', 'Black and White' (along with its regional lines), and 'Puriti' filtered milk.

The company is heavily reliant on its retail clients, with 64% of its 2009/10

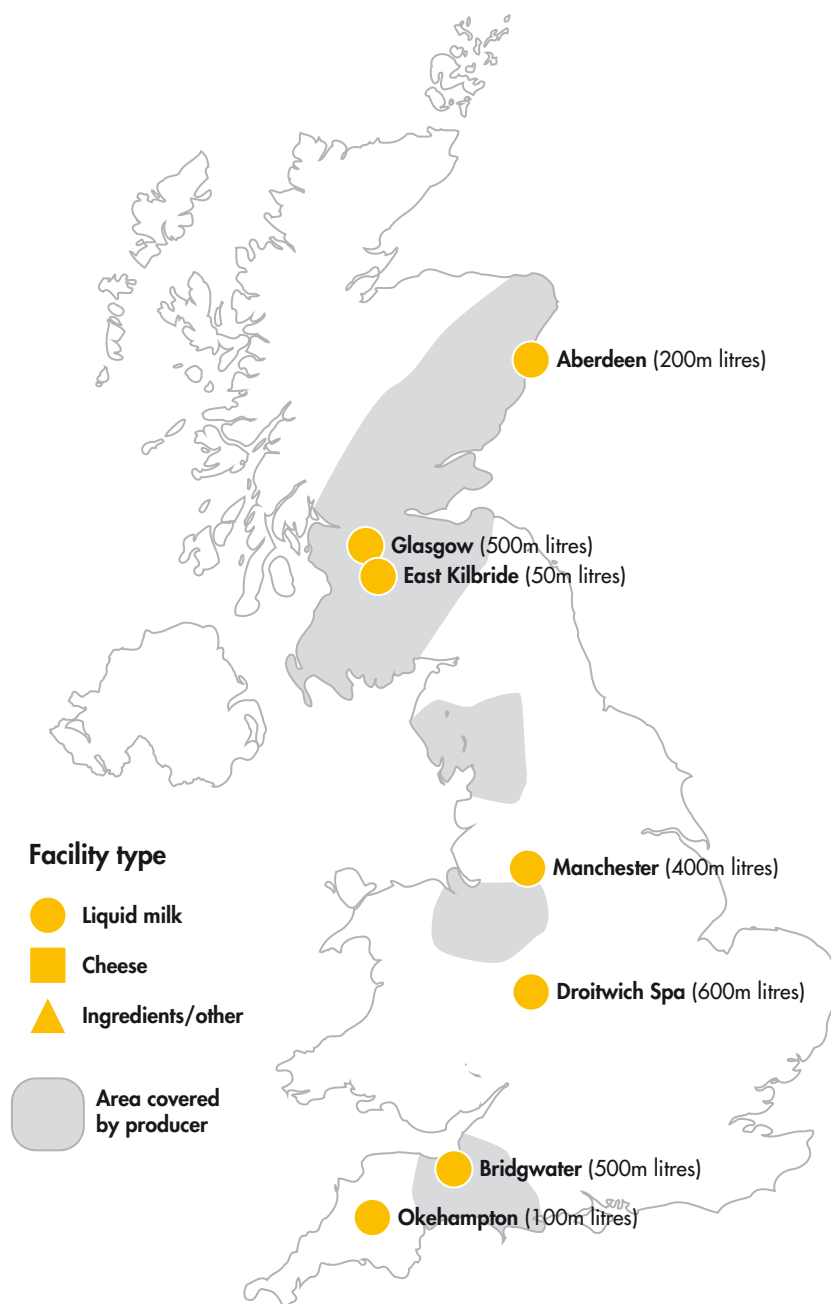
volumes³³ (1,130m litres) sold to three large multiples. Of this total, approximately 72% of the volume (810m) was on aligned contracts. Wisemans also have a strong presence in the middle market, including discounters and freezer centres. This market accounted for 36% (640m litres) of volumes sold during the last milk year.

With such a large proportion of milk sales aligned to only a few large customers, Wisemans faces a danger in its strategy of selling too much milk to any one company. According to the company in its 2009/10 annual report, *"...a large percentage of the Group's sales are made to Multiple Retailers and, in the period to 3 April 2010, 73% of our total milk sales by volume was concentrated in five key customers (compared to 76% in year ended 4 April 2009)"*. Should retailers drop volumes on aligned contracts, there will be a need to find alternative markets for the milk the company is contractually obliged to buy from direct suppliers. Those farmers on aligned contracts will also face the risk of being moved to the non-aligned contract and receiving the lower price.

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33 Percentages given in Note 3 in 2009/10 annual report.

D.



Robert Wiseman operates out of seven processing dairies, located centrally within its milk fields and accessible to major transport routes. The most recent addition to its facilities is the Bridgwater dairy which became fully operational in September 2010 with the capacity to process 500m litres per annum at a cost of £8.1m in the 2009/10 financial year and a further investment of £9.5m in 2010/11, making total investment in the site of approximately £100m.

During 2009/10, the company was near to full utilisation of capacity, however increases in capacity at Bridgwater has eased this, and according to the latest trading update, there is currently around 125m litres of available capacity. It may be for this reason that the company announced in January 2011 that the Okehampton dairy is to close, taking 50-100m litres of capacity out of operation. With a near term target to increase total milk production to 2 billion litres, this may see the company return to the situation where there is little available capacity for future growth.

Wisemans invested £9.7m on the Amesbury and other depots during 2009/10, along with £2.3m on its dairies other than Bridgwater. Further investments are planned for the depot Market Drayton (£1.5m) and to double the capacity for filtered milk at the Droitwich Spa facility by the summer of 2011 (£8m). The company owns its own distribution fleet and has a continuous programme of investment, totalling in the region of £10m per year.

Markets

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The liquid milk market in Britain grew by just under 1% in the year ending 21 March 2010 according to Kantar Worldpanel data to 5.03 billion litres. Robert Wiseman Dairies held around 35% of the retailer own-label market, which was down marginally from 36% in the previous year. Over the same period, RWD accounted for around 61% of volumes sold in the 5 major discounters and freezer centres³⁴.

Total sales volumes to the major retailers dropped during the period by 12%, partly due to changes in supply contracts and partly due to the 9% decline in retail sales of own-label milk. However, contracts with freezer centres, discounters and distributors, along with a 44% increase in sales volumes in these outlets, will have had the likely impact of increasing volumes sold to this sector of the market³⁵.

The main changes in retail contracts since the end of the last financial year are summarised below:

Retailer	Contract	Share
Tesco	Contract renegotiated in December 2010	Share of own label increased to 55%
		Share of 'Creamfields' reduced to 50%
Sainsbury's	Contract renewed to October 2013	Maintained 50% share
Cooperative*	Contract renegotiated in August 2010** to increase volumes by 30m	Share increased to 75%
	Lost contract for 'value' milk from October 2010	

*Integration with Somerfield stores now complete so total volumes have increased.

** This contract is to be renegotiate in the spring of 2011 when the Co-operative introduce a dedicated supply chain.

Growth areas for Wiseman Dairies are the increased production of filtered milk and the supply of Tesco's low fat milk 'Creamfields'. Filtered milk is one of the fastest growing segments of the milk market, accounting for 6.5% of the total liquid market in the year ending 21 March 2010, compared to 5.6% in the previous year. This represents growth in volumes of 17.2% year on year. With the investment to increase its capacity to supply filtered milk, Wisemans will be able to benefit from this growth.

Low fat milk accounted for 5.2% of total retail milk sales volumes during the 2009/10 milk year, up from only 2.2% the previous year³⁶. There are four main 1% fat products on the retail market, of which Wiseman Dairies produce two – 'Creamfields' and 'The One'. Together,

³⁴ Iceland, Farmfoods, Aldi, Lidl and Netto

³⁵ Figures for sales to discounters and freezer centres for the previous year are unknown so year on year comparisons cannot be made.

³⁶ Kantar Worldpanel (52 weeks ending 21 March 2010 vs. 52 weeks ending 22 March 2009)

these two products accounted for around 40% of the market in the year ending 21 March 2010, and have shown an increase of 61% in sales volumes from the previous year.

Volumes of Wiseman Dairies branded milk sold in the year ending March 2010 declined by 6%, primarily due to the replacement of its '*freshnlo*' brand in Tesco stores with the supermarket's tertiary brand '*Creamfields*'. As this is also produced by Wisemans, total volumes processed will not have been affected.

D.

Highlights...

- Holds a large share of the retailer own-label milk market, although further volume gains from this market are limited as many long-term contracts were negotiated during 2010.
- The company is increasing production of low-fat and filtered milk, both of which are growing markets.
- Increased presence in middle market with new or extended contracts to supply larger discounters and freezer centres.

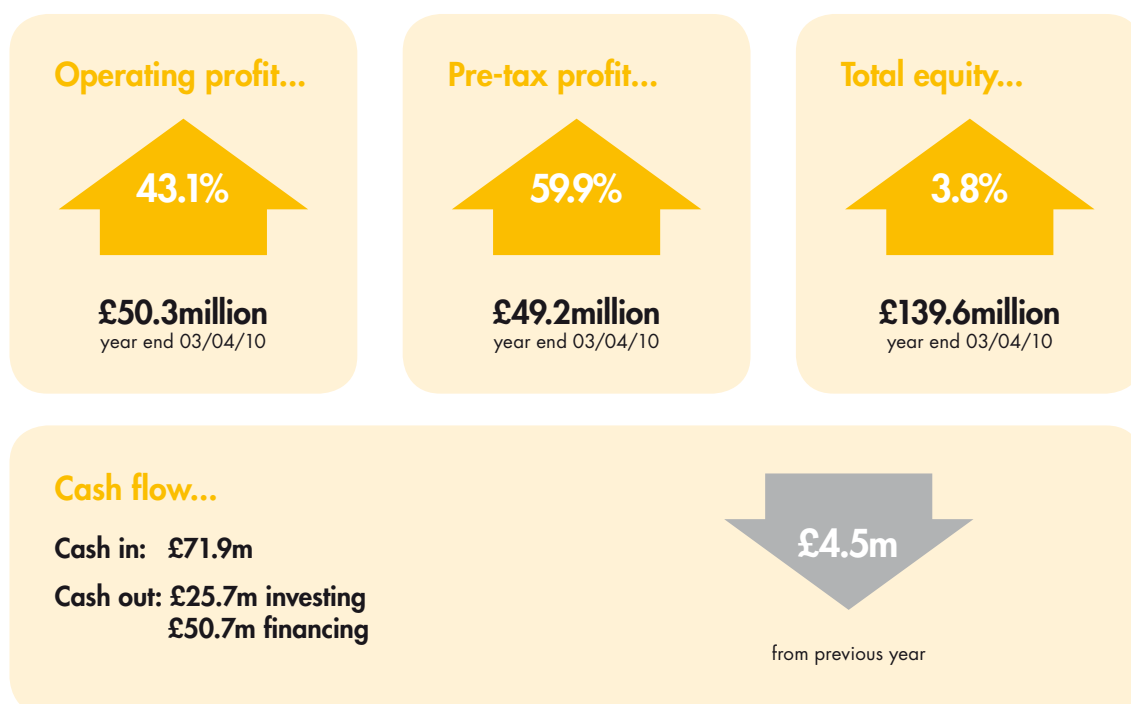
Robert Wiseman Dairies

Financial analysis.

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Headline figures

Headline financial figures and ratios have been calculated from the most recent full set of accounts for the Robert Wiseman Dairies group. Operating profit figures do not include gains or losses from exceptional items. The definitions of the financial figures and ratios are available in the Appendix at the end of the report.



- Operating profit increased from the previous year.
- The impact of an increase of 6.1% in volumes sold on turnover was partially offset by lower selling prices, reducing turnover by 2.19ppl (4.2%) to 50.07ppl in the year ending 3 April 2010.
- Turnover fell a further 2.69ppl in the six months to 2 October 2010 to 47.38ppl.
- The proportion of turnover derived from cream revenues increased to approximately 12% for 2009/10.
- Costs of sales were reduced by 2.3ppl to 38.84ppl during the year which will have been influenced by the lower milk price paid.
- Combined with a reduction in operating expenses of 0.57 pence per litre on average for the year (resulting from high utilisation of processing facilities and efficiencies gained from new investments at Bridgwater) mean

that overall operating profit increased by 0.67ppl to 2.84ppl.

- The six-month trading update reported a decrease in operating profit resulting from higher operating expenses and lower selling prices. This is expected to result in a £16 million reduction in trading profit for the 2011/12 financial year.
- A reduction in finance costs further aided profit growth.
- Profits per litre before tax increased 59.9% to £49.2m (not accounting for the one-off OFT penalty reduction).
- Equity has increased to same level as in April 2008, in part due to the increase in retained earnings.
- After investment in Bridgwater, they have maintained the ability to fund the business and provide a good return.
- Higher volumes have reduced total equity per litre by 0.4ppl (4.9%).
- A relatively high cash balance at the beginning of the financial year due to planned investments in Bridgwater.
- The high level of cash used for financing can be attributed to dividend payments, purchase of own shares and the reduction of debt.
- Cash flow has shown a net gain of £0.5m in the six month period to October 2010 despite a £12.0m outflow for investment.

D.

Financial ratios

Profitability ratios

Gross margin 22.4%

- 1.1 percentage points up on previous year.
- Relatively stable over time, increase due to reduced cost of sales and growth in volumes during period.
- Is a good return and one of the better results of the companies included in this report.

Pre-tax profit margin 5.6%

- Improvement from a 3.6% pre-tax profit margin for previous year.
- Indicates increased efficiencies of production and ability to control costs (e.g. milk prices) or negotiate higher prices from customers.
- Better than average for the industry.

Return on capital employed (ROCE) 30.6%

- Up from 20.7% in previous year.
- Indicates that the company is efficient and generating profits from their assets.
- The recent investments in new production facilities will have positively impacted the ROCE ratio.

Debt ratios

Quick ratio 0.60*

- Reduced from 0.66 in previous year.
- Impacted by rise in value of inventories of 18.1%.
- Slightly lower than average, but is at a comfortable level.

Current ratio 0.70

- Down from 0.76 in previous year.
- Indicates that available assets are not quite sufficient to meet current liabilities although impacted by significantly higher accruals for the year, increasing total liabilities.

Gearing 15.0%

- Reduced from previous year ratio of 20.6%.
- Company tends to fund capital investment out of retained earnings, keeping its gearing ratio low.

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*while this deducts inventories from total assets, the company's inventories can be considered to be easily convertible to available cash and therefore the quick ratio is a slight understatement of the company's liquidity.

Efficiency ratios

Debtor days 29.7

- Up by 5.1 days from last year.
- Collecting receivables slower which will impact liquidity (see quick/current ratio).
- Approximately 58% of trade creditors are multiple retailers.

Creditor days 41.3

- Up by 3.1 days from previous year.
- In typical range for industry.

Stock days 6.6

- Due to the nature of the business, inventories are not a primary feature, so a low figure is expected.
- Marginally higher than typical figure of around 6.0 days.

Highlights...

- Has a strong financial position, with little long term debt and low gearing.
- Increased costs of sales due to increased prices of inputs (oil, plastics) but lower milk prices paid through 2009/10. With increased volumes, costs per litre processed have been reduced.
- Profit warning issued with October 2010 trading update due to impacts of competition amongst three large liquid milk processors to secure supply contracts with major retailers.

Annex 1 - Financial ratio calculations.

D.

Financial Headline Figures & Ratios	Calculation	Description	Interpretation
Operating Profit	Turnover less cost of sales NOT including exceptional or non-recurring items	Profit after cost of sales and overhead expenses (not including exceptional items), but before interest and tax	Indicates the efficiency to which a company generates profits from operating activities.
Pre-tax Profit	Profit before tax	Profit after all costs, including finance costs, exceptional and non-recurring items, but before taxes	The profits available to be disbursed to shareholders or added to reserves (before tax).
Total Equity / Member Reserves	Issued capital plus reserves and revenue reserves	Shareholders or members' funds	Needs to be examined in light of the direction of change over the past two to three years.
Gross margin percentage	$(\text{Gross profit (Turnover less cost of sales)} / \text{Turnover}) \times 100$	Shows how much it costs to get goods and services ready for sale.	Indicates the amount of money the company has available for overheads from its turnover.
Pre-tax profit margin percentage	$(\text{Pre-tax Profit} / \text{Turnover}) \times 100$	Shows how efficient the company is at generating profits from sales	Indicates the amount of money the company has available for purposes of taxes and dividends, and also for re-investing in the company.
Return on capital employed (ROCE)	$\text{Operating profit (as above)} / \text{Capital Employed (equity plus long term loans)}$	Measures performance as a whole taking into account all sources of funding	Considered a good measure of efficiency.
Quick Ratio	$(\text{Current Assets} - \text{Inventories}) / \text{Current Liabilities}$	Similar to Current Ratio but with stocks removed (stocks are traditionally less liquid).	As per Current Ratio. Can vary due to nature of inventories as some are more available for sale than other (i.e. butter v. Cheese).
Current Ratio	$\text{Current Assets} / \text{Current Liabilities}$	Indication of business liquidity	Values greater than one indicate sufficient liquidity to meet current liabilities. Large businesses can operate at lower levels than smaller businesses.
Gearing	$\text{Long term loans} / \text{Capital Employed (equity plus long term loans)}$		
Debtor Days	$\text{Trade Receivables} \times 365 / \text{Turnover}$	Measures how long, on average, it takes for the company to collect its debts	Generally should be lower than creditor days. If it is rising raises questions about the company's ability to collect money and may induce cash flow problems.
Creditor Days	$\text{Trade Payables} \times 365 / \text{Cost of Sales}$	Measures how long, on average, it takes for the company to pay its creditors	Generally should be higher than debtor days.
Stock Days	$\text{Inventory} \times 365 / \text{Cost of Sales}$	Measures the average period during which inventories of goods are held before being sold or used in the operations of the business	If it is low, has implications for holding and storage costs as inventory has to be held somewhere. Typically higher for products such as cheese which require maturation time.

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