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Cheddar supply chain margins 2012/13

DairyCo



Agriculture & Horticulture
DEVELOPMENT BOARD

Cheddar supply chain margins 2012/13

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All figures within this document are as accurate as possible; however, the nature of the information means that all reported figures are averages and approximations. This means that there is a small margin of error from precise figures for individual companies, retailers, contracts, etc. However, all changes should be representative of what has happened over the past decade.

Introduction: About this report

How the Dairy Supply Chain Margins report is compiled

For the past decade, DairyCo has been identifying the main beneficiaries within the dairy supply chain when farmgate, processor, retailer or dairy market prices change. This information has been collated annually into the Dairy Supply Chain Margins report.

The information sources for these reports have been farmgate milk prices, wholesale and retail prices on Cheddar cheese and (up until 2011) liquid milk. From this data, DairyCo has estimated the gross margins¹ at processor and retailer level, and compared these with calculated gross margins for the previous two years to highlight short-term trends.

This tenth report, Cheddar Supply Chain Margins 2012/13, identifies who benefitted from changes in prices along the supply chain in the sale of mild and mature Cheddar across the 2012/13 milk year (April 2012 to March 2013).

Gross margins for the 10 previous years are also included to indicate long term trends. Farmgate prices are included but not farm gross margin data as this report focuses specifically on post farmgate margins; information on farm margins can be found in a number of other studies currently available in the industry.

Why does this report focus solely on Cheddar?

As a result of significant consolidation within the dairy processing sector, it has not been possible to obtain reliable data on wholesale prices for liquid milk since 2011. Efforts have been made to develop an alternative method for estimating this, however, these have been unsuccessful.

Due to recent investments in Cheddar production and its growing importance for milk utilisation in the UK, DairyCo has made the decision to continue compiling the report based solely on the Cheddar supply chain.

How should this information be used?

This report provides the transparency and data required to improve farmers' negotiating positions with their supply chain counterparts. It must be noted that the data provided is an average indication across each part of the supply chain and figures for individual businesses will vary. However, the averages are sufficient to highlight areas that could prompt further discussion.

How to access up-to-date information throughout the year

The weekly Datum dairy market update and monthly reports from DairyCo act as a regular guide to changes in the market and prices. Go to www.dairyco.org.uk/market-information to sign up to receive these.

¹ Gross margin is the difference between the selling and buying price. For the purpose of the report, gross margins are calculated as unit gross margins, measuring the unit selling price less the unit cost price (in pence per litre of milk terms). Margins do not account for sales or production costs and are therefore not indicative of profit levels.

Executive summary

The beneficiaries of changes in price within dairy supply chains are a constant source of speculation within the industry. This report seeks to identify them within the Cheddar cheese supply chain, using information on farmgate milk prices and average gross margins made by processors and retailers on the sale of mild and mature Cheddar.

Average UK farmgate prices rose by 11.6% in 2011/12 but in 2012/13 the average farmgate milk price only rose marginally by 1.2% to 28.4ppl. Farmgate prices came under pressure when world commodity markets for dairy fats collapsed in the first half of 2012/13 due to a surge in global milk supplies. Prices recovered through the second half of 2012 and early 2013 as adverse global weather conditions brought a sharp correction to the balance of global supplies to market demand.

Wholesale Cheddar prices remained largely stable, reflecting a well-balanced market with steady domestic demand, stronger export demand and lower domestic production, counteracting increased imports from the Republic of Ireland. When wholesale prices for fat-based commodities such as butter and cream collapsed in the first half of 2012/13, the values of protein-based commodities were less affected. This was largely due to high demand for whey protein and a steady demand for cheese from the growth of 'middle class' consumers in emerging markets. With wholesale Cheddar prices over the past three years remaining stable, processor margins have been squeezed to absorb an increase in farmgate price during this period. This squeeze in processor margins may have been partially off-set by stronger returns from whey powder during this period.

Retail margins accounted for just under half of the retail selling price during this period. In 2012/13, retail margins for mild Cheddar increased to 49% – the highest level recorded since this report began. This was achieved on the back of substantial price increases within some major retailers for private label mild Cheddar. Retailers' overall revenue has remained largely stable as the volume of sales has declined. The overall revenue achieved by processors, however, is estimated to have declined on the back of lower volumes and static wholesale prices.

At the same time, mature Cheddar sales have remained intensely competitive. Higher value branded mature Cheddar has lost sales volume to lower-value budget varieties. During 2012/13, according to data provided by Kantar Worldpanel, retailers increased the number of temporary price promotions for branded mature Cheddar, although the overall discount offered was reduced.

Consumers, meanwhile, spent more at discount stores and on budget mild and mature Cheddar within major retailers. Whereas multiple retailers were able to increase the price of mild Cheddar, strong brand competition in the mature Cheddar category saw a slight fall in the net average retail price after taking discounting through promotional activity into account. Nevertheless, retailers still managed to retain a margin of 48% on mature Cheddar.

The practice of selling forward on contract may be partly responsible for the lack of movement in wholesale prices on Cheddar markets. As such, the fall in processor gross margins may be a temporary feature of the market.

Review of dairy commodity markets in 2012/13

To understand market movements in 2012/13, it's important to look back to the previous year. Near-perfect milk production conditions across the world in the second half of 2011/12 saw global milk supply exceeding demand. This led to a glut in tradable dairy products early in the 2012/13 year. As can be seen in Figure 1, global commodity markets fell sharply as a result, with butter and cream prices particularly affected.

EU Private Storage Aid butter stocks reached 90,000 tonnes, levels not seen since 2009. Butter stocks in the USA were also 38% higher than in the previous year². However, this supply-driven market volatility did not become as extreme as that witnessed in the 2009 trough following the global financial crisis in 2008, when global demand faltered.

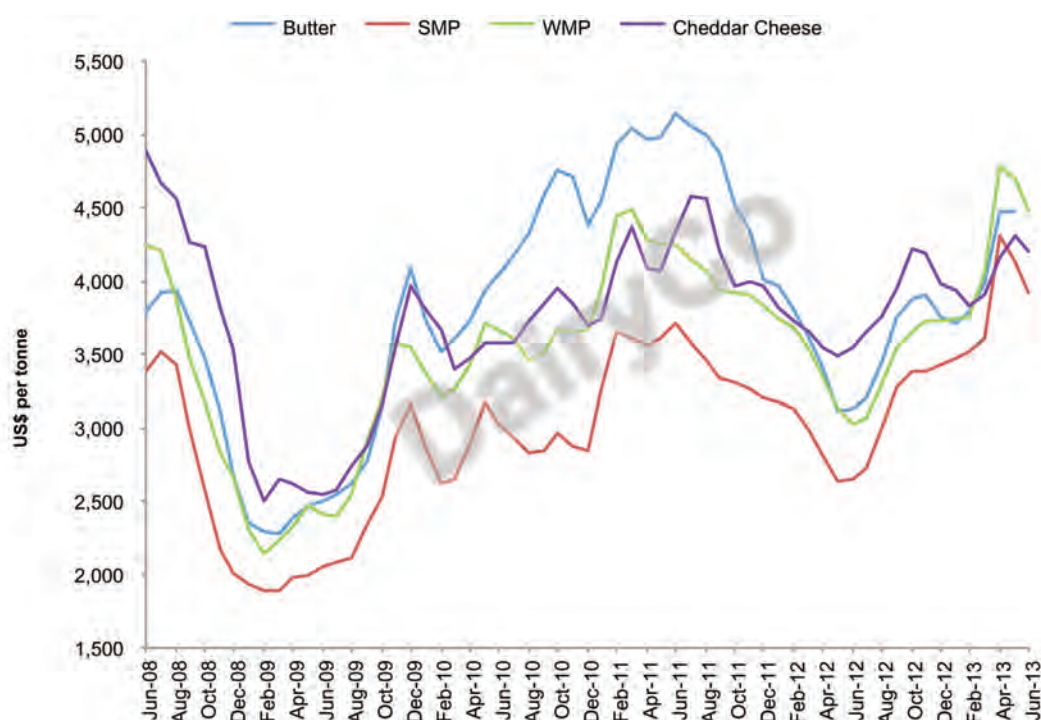
By mid-2012, trader confidence had returned to the market place and global dairy markets started to rebalance. Prices returned to an upward trajectory from June 2012 as milk supplies began to tighten and tradable stocks reduced. The continuation of extreme wet and cold weather conditions in Europe and drought in the USA brought about a sharp rebalancing of global milk supplies by the end of 2012.

Less-than-ideal milk production conditions in the southern hemisphere from November to February in 2012/13 further tightened supplies. This resulted in less milk going into powder production, despite demand from emerging economies remaining resilient. By April 2013, world whole milk powder (WMP) and skim milk powder (SMP) prices had hit record levels averaging \$4,790/tonne and \$4,304/tonne respectively.

The surplus milk supplies in the first half of 2012 also led to an increase in world cheese production. Although Cheddar stocks increased in 2012/13 as a result, wholesale Cheddar prices remained more resilient to the mid-2012 downturn. With plenty of global stocks available to meet demand, Cheddar prices did not spike to the extent of powders in the first half of 2013. However, with global commodities in general remaining tight, despite softer demand growth from emerging countries, there is likely to remain support for current price levels throughout 2013.

² Source: CLAL

Figure 1: World dairy commodity prices

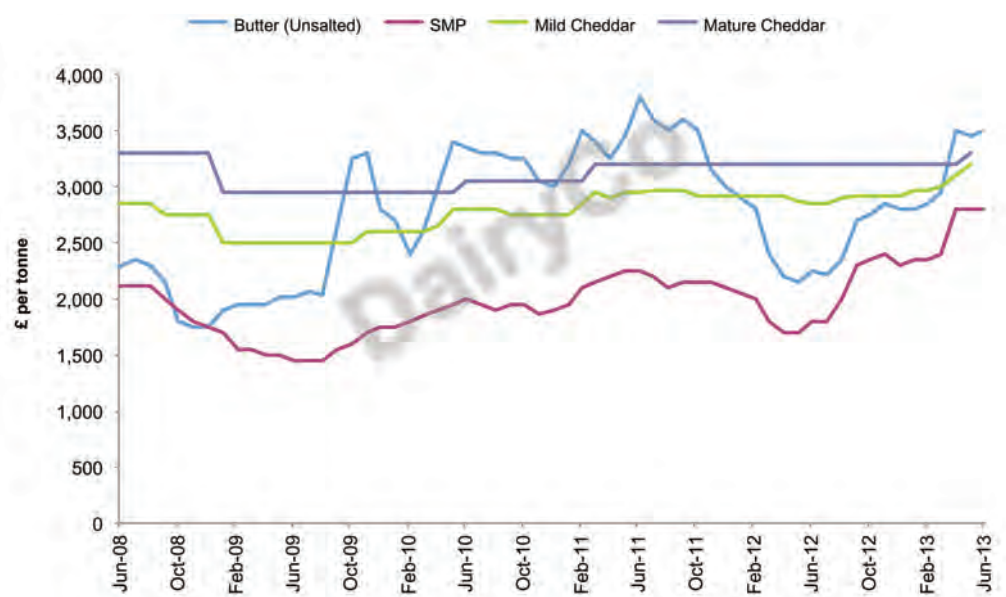


Source AHDB/DairyCo

Butter and powder wholesale markets in the UK followed similar patterns to the global market. As EU butter stocks started to build in 2012 there was no market appetite for the surplus fat following the 2012 spring flush of grass. As a result, UK wholesale butter and cream prices, which had been falling since the second half of 2011, dropped even further to levels not seen since the trough of 2008/09.

UK Cheddar markets, underpinned by strong export demand (up 6.4% in 2012), showed more stability during this period of volatility. Growing demand for cheese from emerging markets (such as China) due to expanding middle classes, supported a growth of 14% in EU cheese exports during 2012. UK domestic demand for Cheddar also remained robust throughout 2012/13.

Figure 2: UK wholesale prices



Source AHDB/DairyCo

Between 2011/12 and 2012/13, demand for raw milk supplies for Cheddar increased due to an expansion in UK dairy manufacturing capacity and demand for high quality whey protein. However, UK milk production fell by 4% (500m litres) in 2012/13 because of the poor weather. This adversely impacted production levels of Cheddar in early 2013 as processors strove to meet obligations to retailer liquid contracts. Spot milk prices spiked to reflect greater demand pressures and returns from Cheddar manufacture consequently appeared less commercially attractive for some processors.

According to Defra, UK cheese production (accounting for 28% of the milk utilised in 2012/13) was down 4.8% in 2012/13 over the previous year, with March 2013 production specifically down 16.7% on levels 12 months previously. In May 2013, UK wholesale prices for mild Cheddar spiked at a record £3,200/tonne and mature Cheddar prices, at £3,300/tonne, reaching levels last seen in 2007/08. As a result, the price premium between wholesale mild and mature Cheddar narrowed to just £100/tonne.

In the wider EU, where around 60% of milk produced is destined for cheese, a tight milk supply situation has so far seen less milk channelled into commodities such as powders and butter throughout 2013, with processors maintaining cheese production levels.

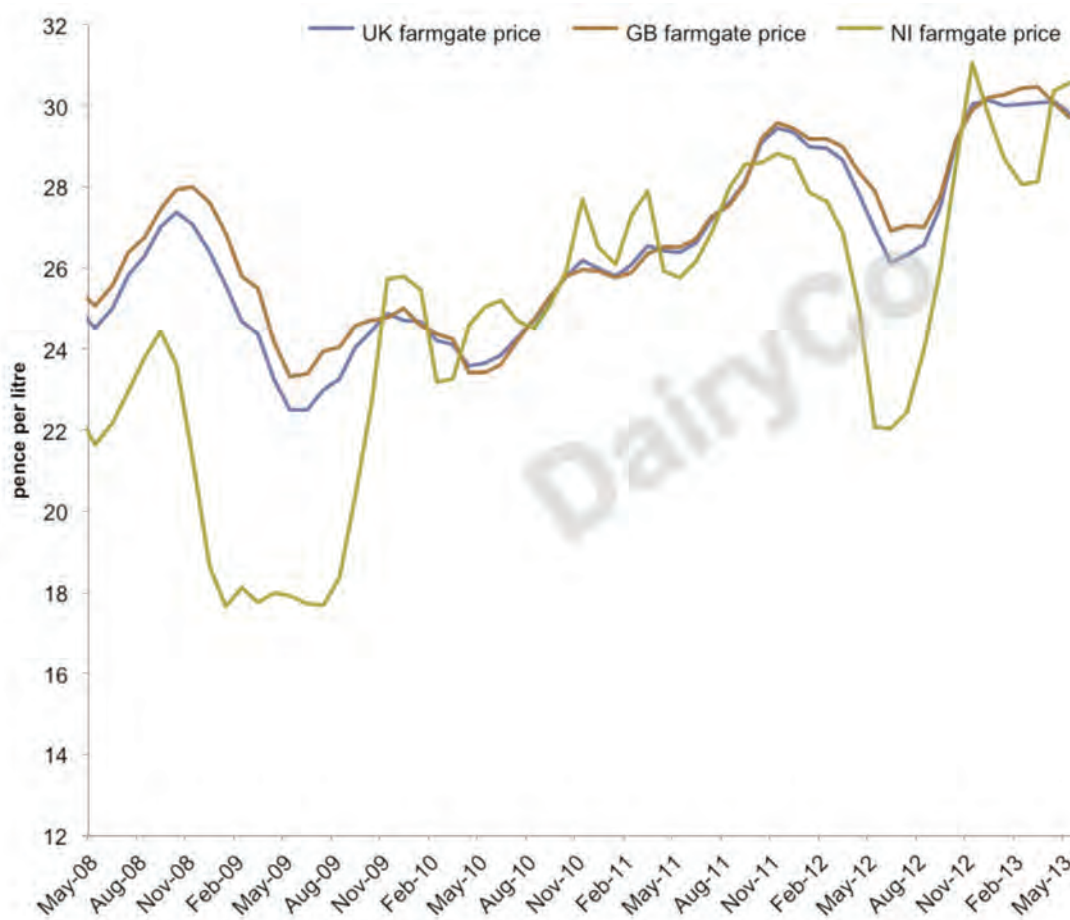
Average UK farmgate prices rose by 11.6% in 2011/12 but in 2012/13 they increased only marginally by 1.2% to 28.4ppl. One of the causes was a collapse in wholesale butter and cream prices during the first part of 2012/13, which initially caused UK average farmgate milk prices to fall back. This led to a 'dairy crisis' as cash-strapped liquid processors announced reductions to farmgate milk prices between April and June 2012 of up to 4ppl.

A fall in GB farmgate prices to 2009/10 levels was only averted through supply chain intervention, co-ordinated through a specially formed Dairy Coalition of farming organisations. This intervention resulted in temporary financial support offered by some major retailers until wholesale prices sufficiently recovered in the second half of the 2012/13 milk year. The crisis and subsequent supply chain intervention also provided additional impetus for supply chain reforms, such as the Voluntary Code of Practice³.

³ Further details of the Voluntary Code are published by the NFU, see <http://www.nfuonline.com/assets/6570>

This tells some of the story about commodity markets in GB over the 2012/13 milk year. In summary, a higher proportion of GB milk was directed into domestic markets in the form of liquid milk and Cheddar cheese and sold under supply contracts. In Northern Ireland (NI), the story is different. Milk production is primarily directed to export markets in the form of powders, butter and commodity cheese. As such, NI farmgate prices were particularly exposed to the sharp downturn in world commodity markets in the first part of 2012/13, with farmgate prices reacting more quickly and directly than in GB. This was demonstrated by the rapid increase in NI farmgate prices (+9ppl) between June 2012 and November 2012. In GB, farmgate prices moved just over 4ppl during this period. NI farmgate prices had also fallen sharply to around 22ppl in the first half of 2012/13, before reaching record levels of around 31ppl in the second half, as supplies tightened in the adverse weather conditions.

Figure 3: Average farmgate milk price



Source Defra, DARDNI, RERAD⁴

The impact that changes in commodity markets and farmgate milk prices have had on margins within the supply chain are discussed in the next section.

⁴ See Appendix for full details

Mild Cheddar margins

Mild Cheddar markets

UK mild Cheddar markets have been characterised by relative stability over the past three years. Favourable exchange rates and strong export demand have counterbalanced imports. Together with robust domestic demand and stable production, this has kept the UK mild Cheddar market well-balanced and has curbed price movements at wholesale level.

A summary of the key drivers which have impacted on the market for mild Cheddar during the 2012/13 milk year is provided in Table 1.

Table 1: Key drivers in mild Cheddar markets 2012/13			
Key drivers	Price impact 1st 6mths	Price impact 2nd 6mths	Segment
Major retailers increasing the price of own label mild Cheddar during 2012/13 period	↑	↑	Retail
Reduced volume sales of mild Cheddar as consumers cut back on overall grocery expenditure, leading to a decline in sales by volume of both branded and own label mild Cheddars	↓	↓	Retail
Significantly increased sales of mild Cheddar through discount stores (eg Aldi and Lidl) at the expense of large multiple retailers	↓	↓	Retail
An increase in imported Cheddar from the Republic of Ireland in 2012/13 compared with 2011/12		↓	Retail
		↓	Processor
Buoyant wholesale markets for protein-based dairy commodities fuelled by demand for Cheddar from emerging markets and growth of high value protein markets	↔	↑	Processor
14,000 tonnes less cheese produced by UK processors in 2012/13 compared with 2011/12	↔	↑	Processor
Increased competition for raw milk supplies arising from investment in processing capacity and lower UK raw milk production		↑	Farmer
Collapse in commodity markets during first half of 2012/13 and recovery in second half of 2012/13	↓	↑	Farmer
Increase in costs of key farm inputs pushing up farmgate milk prices through those formula-based contracts which include these indicators		↑	Farmer

Impact on prices

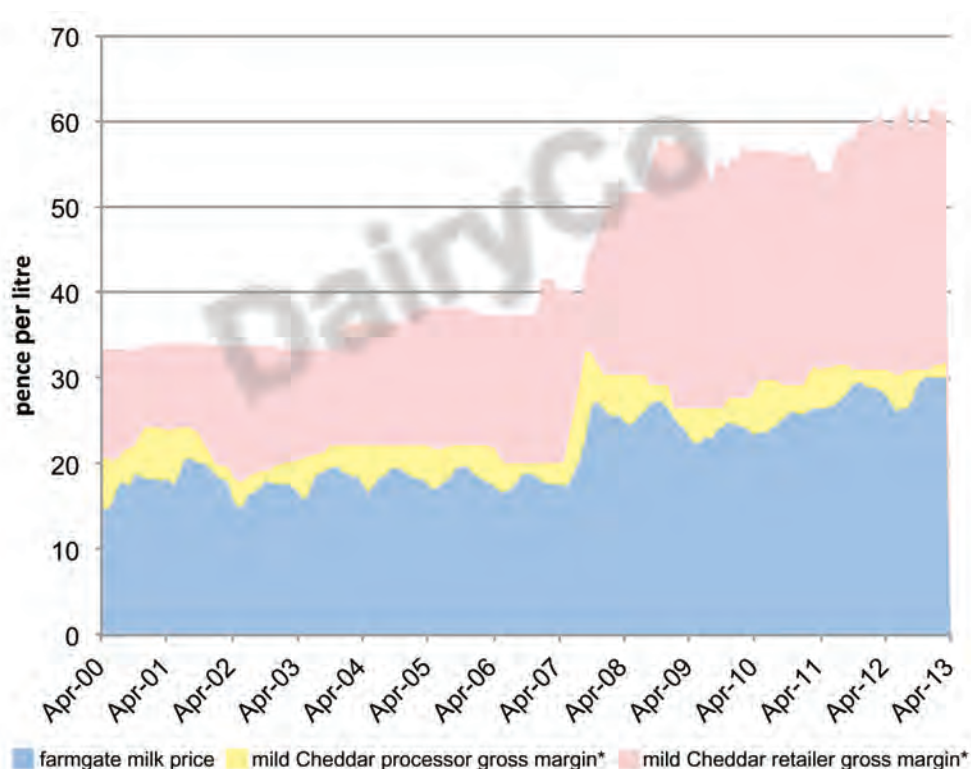
Retail sales of mild Cheddar came under pressure throughout 2012/13 as household incomes continued to be squeezed. According to Kantar Worldpanel data, consumers bought less mild Cheddar but when they did, a greater proportion came from discount stores such as Aldi and Lidl. However, several of the large multiple retailers introduced significant retail price increases during 2012/13. As a result, the net effect on the average retail price of private label mild Cheddar in 2012/13 was a rise of 5%.

Wholesale prices, on the other hand, remained largely stable due to strong export demand, competition for raw milk and global market stability. When the wholesale price collapsed for fat-based commodities such as butter and cream in the first half of 2012/13, prices for protein-based commodities were less affected. This was due to high demand for whey protein and a steady demand for cheese from the growth in middle class consumers in emerging markets.

The relative stability of wholesale prices for mild Cheddar reflects a well-balanced market with steady domestic demand, stronger export demand and lower domestic production counteracting increased imports from the Republic of Ireland.

UK cheese production for the 12 months ending March 2013, at 377,240 tonnes, was down 4.8% (19,218 tonnes) on the previous 12 month period. Wholesale Cheddar prices rose at the end of 2012/13 and have continued to rise into 2013/14. However, increased imports of Cheddar coming in from the Republic of Ireland are reported to have placed downward price pressure on UK processors when negotiating individual contracts with retailers.

Figure 4: Prices and gross margins* for mild Cheddar



Source AHDB/DairyCo

*Please refer to report 'Introduction' for definition of gross margin

Impact on margins

The impact of market developments on the beneficiaries from changes in prices along the supply chain is summarised in Table 2 below.

Measured in pence per litre of milk⁵, the average retail price of private label mild Cheddar was 60.6ppl in 2012/13, 2.9ppl (5.0%) higher than in the previous year. This reflected the substantial price increases introduced by some multiple retailers and enabled retail gross margins on private label mild Cheddar to increase in relative terms by 3.1ppl to 49% of the total retail value.

In 2012/13, farmgate prices averaged 28.4ppl, having fallen then recovered to just marginally higher (1.2%) than 2011/12 levels. Despite some downward pressure on wholesale prices for mild Cheddar, processor margins remained relatively stable at 9% (2.7ppl) in 2012/13.

Table 2: Comparisons of 'Defra farmgate milk price' mild Cheddar gross margins

	2002/03		2010/11		2011/12		2012/13	
	ppl	margin	ppl	margin	ppl	margin	ppl	margin
Farmgate milk price (Defra)	16.9		25.1		28.1		28.4	
Processor gross margin	2.3	12%	4.5	15%	3.2	10%	2.7	9%
Processor selling price	19.2		29.6		31.3		31.1	
Retail gross margin	14.5	43%	25.6	46%	26.4	46%	29.5	49%
Retail price	33.6		55.2		57.7		60.6	

Note Retail prices may differ from previous reports due to reweighting of retail prices from Kantar Worldpanel.

The Defra farmgate milk price used in Table 2 is an average price and covers all aspects of milk processing. However, it is possible to compensate for the distorting effect of premiums paid under retailer-aligned liquid milk contracts. DairyCo calculates the 'typical' farmgate price for raw milk bought specifically for cheese production by using information on cheese contracts collected for the monthly DairyCo Datum milk price league table and is based on the DairyCo standard litre⁶.

Table 3 on page 12 summarises mild Cheddar margins over the past three years using the farmgate price paid on milk for cheese contracts⁷ – ie raw milk which is contracted and priced specifically for Cheddar production.

⁵ Refer to the Appendix for details on how retail prices are converted to a pence per litre basis.

⁶ See <http://www.dairyco.org.uk/market-information/milk-prices-contracts/milk-calculator-and-contracts/league-tables/#Standard%20Litre%20-%202012/13>

⁷ See Appendix for details of the contracts included in this analysis.

Table 3: Comparisons of 'milk for cheese contract' mild Cheddar gross margins

	2010/11		2011/12		2012/13	
	ppl	margin	ppl	margin	ppl	margin
Farmgate milk price	24.1		27.4		27.9	
Processor gross margin	5.5	19%	3.9	12%	3.2	10%
Processor selling price	29.6		31.3		31.1	
Retail gross margin	25.6	46%	26.4	46%	29.5	49%
Retail price	55.2		57.7		60.6	

Note Retail prices may differ from previous reports due to reweighting of retail prices from Kantar Worldpanel.

Standard litre data was not available by contract type until 2005. As such, there is no comparable data for the 2002/03 milk year

The typical price paid for milk on cheese contracts over the past three years has been lower than the Defra average farmgate prices, although the gap has been closing from 1ppl in 2010/11 to 0.4ppl in 2012/13.

Again, measured in pence per litre, processor margins for 2012/13 decreased from 12% to 10%. However, the change in methodology also highlights a relative fall in gross margins over the longer period, with processor margins appearing to have reduced from 19% to 10% over the past three years. This emphasises the impact of increasing competitiveness for raw milk in GB, with farmgate prices paid on cheese contracts moving closer to prices paid on aligned liquid contracts.

At retailer level, branded mild Cheddars account for a relatively small proportion of the total mild Cheddar segment (6.4%) in terms of volume sold but tend to be priced in line with branded mature Cheddars. This gives the retailer scope to charge a strong premium over own-label mild Cheddars. In 2012/13, when expressed in terms of pence per litre, branded mild Cheddars achieved a premium of 12.8ppl (21.1%) over private label mild Cheddars. A similar premium was achieved in 2011/12, showing that increases in branded mild Cheddar retail prices have kept in line with private label mild Cheddar price rises.

It's important to note that costs are not included in this analysis and that a change in gross margin or the share of retail price does not necessarily equate to a change in profit levels. Differences exist between businesses both along and at the same stages of the supply chain in areas such as cost structure and level of production efficiency, which will determine the relative profitability of any business.

While it appears that processors' gross margins for private label mild Cheddar have been reducing over the past three years, these may have been balanced against gains in other areas of the business. Wholesale markets for whey powder, for example, have remained strong during this three year period. For those processors involved in these markets, returns from them may have subsidised the reduced gross margins from mild Cheddar production. In addition, processors investing in new technology and equipment over this period could have realised production efficiencies, providing support against any reductions to net profit margins.

It should also be considered that the fall in processor gross margins will have been influenced by the time lag between milk purchases and cheese sales, due to the maturation period for cheese. The farmgate price in 2011/12 will have been marginally lower, reducing processor costs and influencing selling prices in 2012/13. Therefore the low level of processors' gross margins might turn out to be temporary if higher sales prices are negotiated to compensate for the increased cost of milk.

Mature Cheddar margins

Mature Cheddar markets

Wholesale markets for mature Cheddar in the UK have remained static at 34.0ppl for two years, with prices in 2012/13 remaining unchanged from 2011/12. As with mild Cheddar markets, the lack of any significant growth in production or trade meant the market remained well-balanced and no adjustments to prices were needed.

A summary of the key drivers impacting the market for mature Cheddar during the 2012/13 milk year is provided in Table 4.

Table 4: Key drivers in mature Cheddar markets 2012/13			
Key drivers	Price impact 1st 6mths	Price impact 2nd 6mths	Segment
A slightly lower proportion of branded mature Cheddar on promotion in 2012/13	↑	↑	Retail
A significant increase in the proportion of branded mature Cheddar offered on a temporary price reduction promotion compared to 2011/12 but less discount offered overall	↑	↑	Retail
Less branded mature Cheddar and more budget mature Cheddar purchased by consumers looking to reduce overall value of grocery shop	↓	↓	Retail
Buoyant wholesale markets for protein based dairy commodities fuelled by demand for cheese and milk powders from emerging markets and growth of high value protein markets	↔	↔	Processor
Increased competition for raw milk supplies arising from investment in processing capacity and lower UK raw milk production		↑	Farmer
Collapse in commodity markets for dairy fats during first half of 2012/13 and recovery in second half of 2012/13	↓	↑	Farmer
Increase in costs of key farm inputs which have pushed up farmgate milk prices through formula-based contracts which include these indicators		↑	Farmer

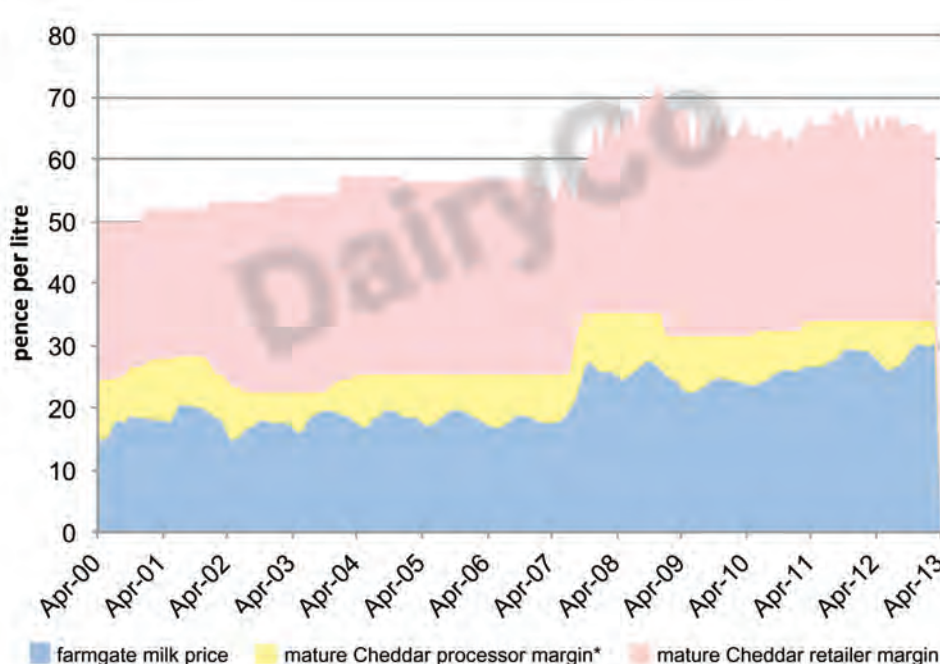
Impact on prices

Similar to mild Cheddar, retail sales of mature Cheddar came under pressure throughout 2012/13 as household incomes continued to be squeezed. According to Kantar Worldpanel data, consumers bought marginally lower quantities of mature Cheddar and a greater proportion of budget private label. This resulted in branded mature Cheddar losing 3% market share. Less branded mature Cheddar was recorded on retailer promotion but there was a significant increase in the number of temporary price reduction offers. This resulted in the overall price of branded mature Cheddar increasing by 2.0ppl (2.9%) in 2012/13. In contrast, the overall average price of private label mature Cheddar decreased slightly in 2012/13; standard packs were priced less than 0.5% lower on average and budget packs around 6% lower compared with 2012/13.

Wholesale prices have remained stable with markets well-matched to domestic and export demand. Recent investment in UK processor capacity in cheese has been equalled by strong demand – but more recently hit by tight milk supplies. An upward price pressure is likely to remain on wholesale mature Cheddar prices with less milk channelled into cheese production throughout the remainder of 2013.

At farmgate level, key farm input costs increased substantially over the course of 2012/13 compared with the previous 12 month period. The trend towards formula-based contracts, which include these indicators, has helped to accelerate the transition of these costs into higher farmgate milk prices for liquid milk. As competition for milk supply has intensified, processors have also introduced additional bonuses for increasing volume to encourage milk flow into liquid processing and manufacturing plants.

Figure 5: Prices and gross margins* for mature Cheddar



Source AHDB/DairyCo

*Please refer to report 'Introduction' for definition of gross margin

Impact on margins

The beneficiaries of these market developments and changes in prices along the supply chain are summarised in Table 5 below, which uses Defra farmgate milk prices.

Measured in pence per litre, farmgate prices averaged 28.4ppl in 2012/13 – just marginally higher (1.2%) than in 2011/12, while average wholesale prices remained unchanged at 34.0ppl. This resulted in a fall in processor margins from 6.0ppl to 5.7ppl. With the extended maturation periods for mature Cheddar, the lag between rising costs and rising wholesale prices is potentially longer than for mild Cheddar. Processors would have therefore purchased the raw milk for production of the mature Cheddar during the 2011/12 period when milk prices were slightly lower. The wholesale selling prices and margins will not yet reflect higher current costs, which could impact 2013/14 margins if wholesale prices remain stable.

Average retail prices for mature Cheddar expressed in pence per litre, at 65.6ppl, were 0.5ppl (0.8%) lower in 2012/13 compared with the previous year. The net effect was a fall in retailer average gross margins. During the course of the year 2012/13, net average retail prices for private label mature Cheddar followed similar patterns to those recorded in 2011/12.

Table 5: Comparisons of 'Defra farmgate milk price' mature Cheddar gross margins

	2002/03		2010/11		2011/12		2012/13	
	ppl	margin	ppl	margin	ppl	margin	ppl	margin
Farmgate milk price (Defra)	16.9		25.1		28.1		28.4	
Processor gross margin	5.8	25%	7.3	22%	6.0	18%	5.7	17%
Processor selling price	22.7		32.4		34.0		34.0	
Retail gross margin	30.6	57%	31.3	49%	32.1	49%	31.6	48%
Retail price	53.3		63.7		66.1		65.6	

Note Retail prices may differ from previous reports due to reweighting of retail prices from Kantar Worldpanel.

The mature Cheddar market is characterised by a high level of sales of branded products. In 2012/13, branded Cheddars accounted for approximately 55% of the market, with budget private label gaining an additional 3% market share compared with 2011/12. Retail prices for branded mature Cheddar averaged 71.4ppl over the same period, which represents an increase of 2.0ppl (2.9%).

Using the typical farmgate price paid for milk on cheese contracts, Table 6 on page 16 illustrates the effect of lower average price paid on estimated processor gross margins.

DairyCo calculates the 'typical' farmgate price for raw milk bought specifically for cheese production by using information on cheese contracts collected for the monthly DairyCo Datum milk price league table, which is based on the DairyCo standard litre. This analysis compensates for the distorting effect the premium paid for aligned liquid milk has on the average Defra farmgate price, which understates processor gross margins for cheese (mild and mature) and excludes any returns made from whey powder.

Table 6: Comparisons of 'milk for cheese' mature Cheddar gross margins ⁸

	2010/11		2011/12		2012/13	
	ppl	margin	ppl	margin	ppl	margin
Farmgate milk price (cheese contract prices)	24.1		27.4		27.9	
Processor gross margin	8.3	26%	6.6	19%	6.1	18%
Processor selling price	32.4		34.0		34.0	
Retail gross margin	31.3	49%	32.1	49%	31.6	48%
Retail price	63.7		66.1		65.6	

Note Retail prices may differ from previous reports due to reweighting of retail prices from Kantar Worldpanel.

The drop in processor margins is more pronounced when considering prices paid on specific cheese contracts, falling from 26% in 2010/11 to 18% in 2012/13. Again, margin reductions have been driven by increased farmgate prices. Elevated competition for raw milk has seen farmgate prices paid on cheese contracts increasing 3.8ppl (15.8%) over the period with no upward movement in wholesale prices. With strong returns from whey and butter, processors may have been able to subsidise higher milk prices and falling returns to mature Cheddar production. Some of the larger UK processors have also recently invested in new technology and equipment, which may have increased efficiencies and helped to reduce costs.

⁸ Standard litre dta was not available by contract type until 2005. As such, there is no comparable data for the 2002/03 milk year.

Conclusions

The 2012/13 Cheddar Supply Chain Margins report highlights considerable challenges faced by farmers, processors and retailers over the past three years. Farmgate prices have been under upward pressure as farmers absorb increased production costs, together with the effects of adverse weather conditions leading to tight milk supplies in the UK.

With wholesale markets for Cheddar remaining well balanced and relatively price-static over the past two years, processors have been unable to pass on increases in farmgate prices to retailers. Using the Defra average farmgate price, this has reduced processor margins in relative terms to under 3ppl on private label mild Cheddar. This leaves little room for processors to absorb any further rises in average farmgate prices without corresponding increases to wholesale prices.

Retailers have seen Cheddar sales volumes reduce as consumer household budgets continue to be squeezed. While branded Cheddar remains an important part of the value gain at retailer level, there has been a move towards budget varieties as well as an overall shift in grocery sales through discount stores. In this environment, retailers have significantly increased the retail price of Cheddar, possibly to appear to offer more on discount. The net effect has enabled retailers to increase mild Cheddar prices by 5% while stabilising mature Cheddar prices. Retailers continue to retain just under half of the retail selling price of private label mild and mature Cheddar.

Looking into the future, Cheddar production could continue to be constrained as competition for raw milk supplies remains throughout 2013. In the wider EU, where around 60% of milk produced is destined for cheese, a tight milk supply situation is expected to see less milk channelled into commodities such as powders and butter in 2013/14, in order to maintain cheese production at around 2012/13 levels. However, in the UK, where liquid milk dominates the dairy market sector, there are already signals that less milk is being directed into Cheddar production. With UK farmgate prices continuing to rise in the first half of 2013/14, processors could see Cheddar margins eroded to a point where scaling back production and/or diverting milk into other markets is either financially sensible or a financial necessity. It is therefore possible that UK Cheddar production may be constrained until milk supplies increase, farmgate prices stabilise or UK wholesale prices move upward to a point where margins are attractive.

Appendix

Data sources

The following is a list of the data used in this report, the source and its characteristics.

Farmgate milk prices

Farmgate milk prices are provided by Defra on a monthly basis and represent average prices received by farmers, net of delivery charges and excluding any retrospective bonuses. The prices are obtained from a monthly survey of registered milk purchasers across the UK, which record volume, value and protein content of milk purchased. All major milk purchasers (those purchasing over 2 million litres of milk per year) take part in the survey and approximately 91% of milk purchased from UK farms is accounted for.

The Defra published prices are weighted according to the volume of milk purchased and averages are, therefore, influenced by the larger milk purchasers.

For the supply chain analysis, annual average farmgate prices are not weighted but are simple averages of the twelve months of data.

Milk for cheese contract prices

For comparison purposes, a typical price paid for milk for cheese was calculated using the DairyCo standard litre milk prices for a basket of cheese contracts.

www.dairyco.org.uk/market-information/milk-prices-contracts/milk-calculator-and-contracts/league-tables/ These included the Dairy Crest Davidstow contract, First Milk's compositional and Highlands & Islands contracts, Milk Link's manufacturing contract and Joseph Heler's and Wyke Farms' contracts.

Wholesale prices

UK wholesale prices are collected on a monthly basis and, for the supply chain analysis, annual averages are a simple average.

UK wholesale prices for cheese, butter, powders and cream are collected monthly by DairyCo by obtaining quotations from traders and milk processors and indicative prices are published www.dairyco.org.uk/market-information/milk-prices-contracts/wholesale-prices/uk-wholesale-prices/

For mild and mature Cheddar, prices collected are based on spot prices and relate to larger quantities of a container or more on a delivered price basis per tonne. These figures are then converted to a pence per litre (ppl) equivalent using 'industry recognised' milk equivalent conversion factors.

Retail prices

Retail prices for Cheddar cheese are obtained from the Kantar Worldpanel, which collects survey data from 30,000 consumers in GB on the volume and value of purchases. Annual average prices for both mild and mature Cheddar were calculated using 52-week data on expenditure and volume of retail sales. As units sold at retail level are recorded in kilograms, DairyCo converted these to a pence per litre (ppl) basis using the industry recognised 9.4 litres/1 kg cheese conversion factor.

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