Devondale Murray Goulburn Market Update

September 2014

It has been a volatile period for global politics and global dairy trade. The recent Russian trade bans, which includes a ban on Australian dairy, combined with the recent significant price falls on the Global Dairy Trade (GDT) auction, have certainly created a negative sentiment in the global dairy market.

Long-term underlying dairy foods demand from Asia remains strong, with a net reliability on imports to satisfy the ongoing growth in per capita consumption. However, international dairy prices have declined significantly from last year's historic highs, mainly due to production growth in exporting countries, namely New Zealand and the European Union (EU). This impact is compounded by high inventories in China and the recent Russian trade ban on EU, USA and Australian dairy imports.

Given global demand growth, we anticipate some recovery in international commodity pricing, but it is difficult to predict the timing and strength of this recovery.

Given the current market conditions Devondale Murray Goulburn (MG) recently revised its full year forecast for the Southern Milk Region to $6.00 per kilogram of milk solids (i.e. the current farmgate price). This is down from a range of $6.15 to $6.30 per kilogram of milk solids. MG will seek to mitigate downside risk via factors within MG's control, such as cost reductions within the business and product mix optimisation.

Most recently, the European Commission (EC) has announced that it will open Private Storage Aid for butter, Skimmed Milk Powder (SMP) and certain cheeses in order to alleviate the impact of Russian restrictions on imports of EU dairy products and to limit the negative effects on the internal market. The EC has also confirmed that the period for public intervention of butter and SMP will be extended until the end of the year.

Under this scheme, manufacturers continue to own the stock with the EU supporting storage costs. The scheme's aim is to stabilise internal domestic prices and provide an environment where manufacturers are not forced to follow the global market down. Eventually this product will need to be sold at market prices – where, when and how will be important factors to monitor.

Over the next few weeks, MG will assess the impact of the return of the EU to dairy market intervention, the Russian trade ban and further assess China's re-entry in the market.

International dairy ingredients

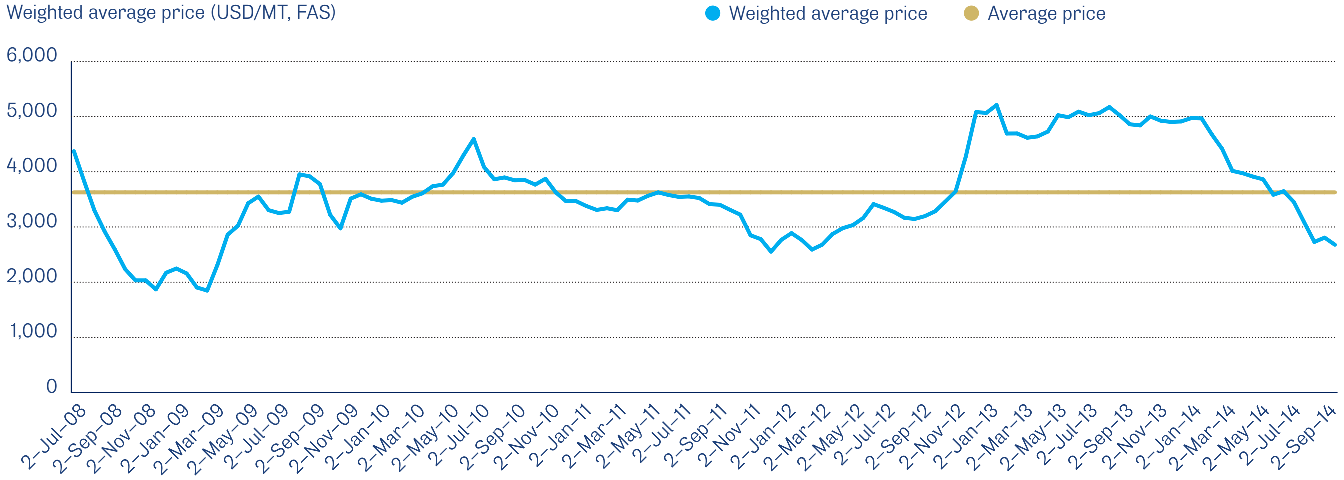
International demand remains generally strong for Australian dairy foods, and to date in 2014–15, MG sales have been relatively strong for all categories.

Two major trade factors combined to deliver the recent declines in GDT ingredients prices:

1. China, the world's largest dairy import market, has been effectively out of the market due to the combined impacts of a recovery in domestic milk production in China and higher than average imported inventory during the first half of 2014. Major global buyers have been non-Chinese destinations, many of whom have stayed out of the market during the high price regime last year.
2. Increased supply from traditional exporters: EU (up 5 per cent), USA (up 1.3 per cent) and New Zealand (up 9.3 per cent). There is now a significant gap between prices reflected on the GDT and domestic prices in USA and Europe for most categories. EU FCMP has been above US$4,000 FOB, as is butter from both the USA and Europe. However, post the Russian ban these prices have started to fall.

Given China's ongoing dependency on dairy imports, we expect global ingredients prices to strengthen as soon as the large Chinese buyers return to the market. This is widely expected to take place later this calendar year or early in 2015. Whilst we expect the international dairy market will turn, we don't anticipate commodity prices will hit the record highs we experienced last year.

Figure 1: Whole milk powder (2 July 2008 – 2 September 2014)



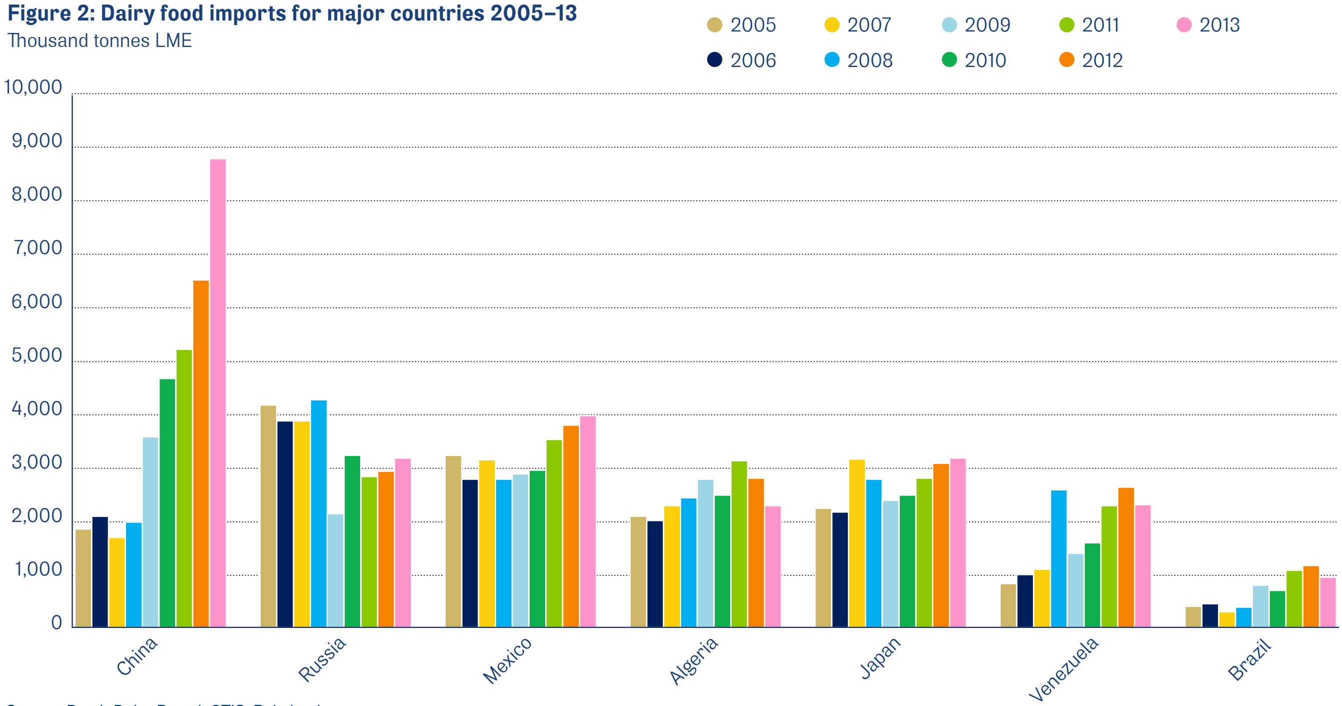
Source: Global Dairy Trade

Russian trade ban

The recently announced Russian trade ban, including Australian dairy, came as a great disappointment to MG. Last year, Russia was an important market for MG, as we sold $94 million in dairy foods, primarily butter, to Russian customers. We will now need to find alternative markets and rebalance our portfolio.

Given the importance of Russia, the world's second largest dairy import market, as an importer of dairy products, particularly from the EU, we will monitor the impact of the ban on global dairy market settings and trade flows.

Figure 2: Dairy food imports for major countries 2005–13
Thousand tonnes LME



Source: Dutch Dairy Board, GTIS, Rabobank

Product mix

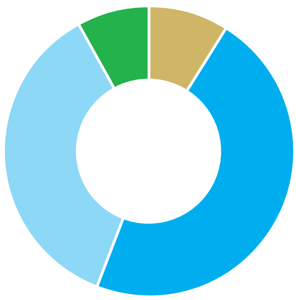
MG is less exposed to international dairy ingredients price fluctuations than before, given our deliberate strategy of diversifying our products and markets portfolio to the less volatile and higher value-add nutritional powders and dairy foods. Our product mix contains a higher ratio of drinking milk, cheese and nutritional powders destined to the grocery and food service channels domestically and internationally.

Figure 3:
2013–14 sales revenue A$

Domestic **49%**
International **51%**

Total revenue: $2.9 billion

Figure 4:
2013–14 revenue distribution



Nutritionals **9%**
Ingredients **47%**
Dairy Foods **36%**
MG Trading **8%**

Currency

The Australian dollar has been stubbornly holding around US$0.93–94 range in recent months. MG continues to look for signs of a weaker Australian dollar to support farmgate prices.

Australian dairy foods

MG has a strong presence in the Australian dairy food market, with approximately 50 per cent of revenues generated via Devondale, contract pack and food service channels. The Devondale Dairy Beverages Centre (Melbourne) has been producing daily pasteurised milk for more than one month as MG enters a new growth market segment. The fully automated plant is one of the most advanced in the world and will service MG suppliers for many years to come. The sister plant in Sydney is also complete, and commercial production commenced in early August 2014. MG's daily pasteurised milk business is expected to generate around $200 million in revenue during the 2015 financial year.

The addition of daily pasteurised milk to our product mix reduces our exposure to commodity markets and currently provides a return above commodity. Liquid milks, including growing UHT sales, raw milk sales and daily pasteurised, means 20 per cent of MG's product mix is now in liquids and delivering profit margins for our business.

Milk supply at MG and Australia

Milk supply received ex-farm increased by 8 per cent in 2013–14 to 3.4 billion litres, including the southern milk pool, the NSW/Sydney region and Tasmania[1]. This represents exceptionally strong growth when compared to Australia's national milk pool, which according to Dairy Australia grew by only 0.4 per cent. MG's share of the Australian milk pool now represents 37 per cent of total milk supply, up from 33 per cent the prior year.

MG's milk supply grew across all supply regions. In northern Victoria and southern Riverina, milk intake was up 1.8 per cent and Gippsland was 3.33 per cent higher and in the western region, which includes western Victoria and South Australia, milk supply grew strongly, up 8 per cent on the prior year. Tasmania also had exceptional growth of 21 per cent.

Important MG updates

Capital structure

Combined capital structure and business update supplier meetings have been announced in the major supply centres for early and mid-September. Meetings in other milk supply regions will be announced soon.

Capital projects

In recent months, MG announced $127 million in major capital projects at existing sites in Victoria and Tasmania. The investments include:

- $74 million in consumer cheese at Cobram (Victoria).
- $38 million in infant nutrition at Koroit and Cobram (Victoria).
- $14 million in dairy beverages at Edith Creek (Tasmania).

These projects are in progress and are expected to be complete late in calendar year 2015.

HerdStart

MG has launched a HerdStart initiative to help young farmers with low equity buy their first herd. For more information, go to www.mgc.com.au.

EBA negotiations – reliability workers

Discussions continue with the unions (AMWU and ETU) and our employees regarding employment agreements. MG has tabled an offer that we believe provides a fair outcome for our employees – one that delivers wage increases above inflation, protects current entitlements and supports MG's business to become more sustainable in the future. While we remain confident that the parties will be able to reach an agreement, some matters at this time are unresolved, with the risk of further industrial action. MG has contingency plans in place should work bans occur.

EBA negotiations – operations workers

Discussions with the union (NUW) and our employees are continuing to progress well.

1 Includes MG's majority owned subsidiary, Tasmanian Dairy Products Co. Ltd.

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