BATORY FOODS

Dairy Newsletter

Dairy Commodities

April 2015

Global Overview

The story at the beginning of the year was the potential abundance of milk going into 2015. The story continues to be milk, milk and more milk in the global marketplace. In the main milk-producing areas of the world, specifically the EU and New Zealand, we have seen a striking turnaround in the amount of milk production. Many of us remember the recent double whammy: a production-ending early drought in New Zealand during a cold, wet spring and government-imposed milk production quotas that kept milk production numbers in the EU dramatically low. The US market became the source to the world for butter and SMP. We are looking at a slightly different picture today.

By all reports, New Zealand finished 2014 ahead of 2013 by more than 1.7 million metric tons, which is roughly an 8.5% growth. The beginning of 2015, which remains a big part of New Zealand's seasonal production period, may not be doing as well. January finished roughly 2.5 million metric tons—nearly even with the previous year. February was down compared to 2014. Even with a poor showing in March, New Zealand will still post gains for their season.

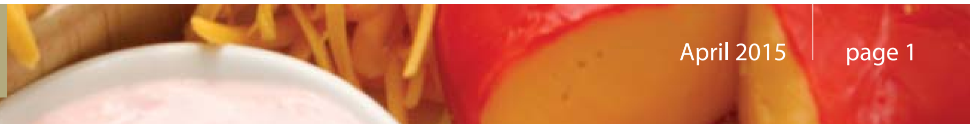
Europe experienced growth in milk production in 2014. This is despite EU-imposed milk production quotas. Milk farmers in Europe have been subject to production quotas for years. If they exceeded those quotas, they faced severe penalties. In March, the quotas are finally being lifted. In preparation for this, the EU has been raising quota volumes annually for the last five production seasons. Still, many large milk-producing countries shot past those increased quotas, resulting in more milk produced in 2014. Without quotas in place and in spite of a lower milk farm gate price, we still expect considerably more milk to be produced in 2015.

US milk production in 2014 was up 2.4% year-over-year with the second half showing a strong 3.5% growth. Lower feed prices have contributed to this good performance. Lower feed costs have led to strong on-farm margins and have encouraged greater production in those areas with farms that purchase feed—namely, the Southwest, West and to a lesser degree the Northwest and East Coast.

It appeared that these strong numbers were continuing into 2015 with January production up 2.1%. However, we have seen a steady decline over the last two months, with February up only 1.7% and March up 1.2%. This decline can be traced to the declines in the Southwest and California, the largest milk producing region.

California experienced declines of 2.6% in January, 3.8% in February and 2.9% in March. The Southwest was up in January but down in both February and March. We believe the declines in the West and Southwest are being driving by lower overall milk prices. In the fourth quarter of 2014, dairy farmers were still experiencing revenues of $20+ per hundredweight of milk. This is the first quarter in which revenue is down to an average of $17.00 per hundred-weight.

While feed prices remain relatively low, the implied margin that farmers are experiencing is considerably less than normal. This appears to be slowing milk production. Add to this the constant threat from the prolonged drought



in California. The lack of water is making it difficult for those who grow their traditional forages. They have had to modify feed rations, which has resulted in lower per cow production.

No discussion of the global dairy market is complete without mentioning currency variations. The trend of a strong US dollar compared to the Euro is hampering US dairy competitiveness. Of late, the US dollar is up 24% based on the US dollar index versus the Euro, down 23%. This spread makes purchases from Europe more appealing and is cutting into the traditional US export customer base.

Dairy Commodity Markets

The majority of commodities have been in decline since the end of 2014. With the exception of a brief rally in the US domestic nonfat market, we have been in a bear market. The US butter and cheese markets are exceptions to this.

From a global perspective, we are looking at a significant amount of milk, with many different factors at work.

Let's look at demand. Two major areas of the world are showing very weak demand for milk products: China and Russia. China's imports at the beginning of the year, mostly SMP and WMP, were down 36%. China bought big in the first half of 2014. Some analysts believe they overbought and are now working off their inventories. Additionally, China's domestic milk production was relatively healthy in 2014. That may be contributing to the lack of import demand, particularly with WMP. There are reports that domestic production may falter in 2015, however, which means a potential return to the world market.

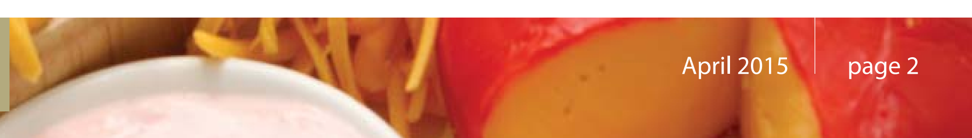
Russian demand has fallen drastically since their trade embargo with Europe over the Ukrainian situation. Russia was a major customer for the EU, particularly for cheese, and the ban has left them at a loss. For perspective, consider these figures: In January 2014, about 39 million pounds of cheese went to Russia. In January 2015, that number has dropped to roughly 200,000 lbs. It's a stark contrast to say the least.

Milk demand to Algeria and the Middle Eastern countries was high, although weak crude oil prices are cutting into what these countries can spend on these imports.

All this milk and falling demand have put considerable downward pressure on prices globally. The NFDM/SMP price has fallen considerably from highs seen in 2014. With the Russian embargo of European cheese, the processors have started up the dryers—moving milk from the cheese vat to powder production. EU SMP exports in January are up 26 million pounds over the prior year, an increase of about 24%.

With demand up only slightly, this new EU powder business is cutting into the US export customer base. With the drop in US SMP exports, drying of milk in the US has switched substantially to nonfat dry milk. This excess product is depressing the domestic price. Despite the aforementioned spike earlier this year, NFDM low heat has fallen on the CME spot market to $1.00 and below.

Dry sweet whey is another area where the price globally has lagged. As with NFDM/SMP, good stocks coupled with anemic demand have at least kept prices flat, if not pushed them down. US exports have fallen, while European exports have grown slightly (-27% vs. +8%). Have we heard this story before? In this case, much of the EU's win is likely driven by the currency valuation discrepancy. It's just cheaper to buy from the EU.



Butter is a unique story, at least domestically. Globally, good supply and tepid demand are keeping prices low. Butter on the last GDT was $1.37/lb, down 7% from the last auction. In fact, butter has continued a slide since mid-February, when it recorded $1.73 on the auction. International prices as reported by the USDA were better than GDT at $1.53 (EU) and $1.52 (Oceania) but still well below the CME domestic market, which recorded a CME average of $1.83/lb (for the week of 4/20).

In the US, the story is stocks. People are taking a look at butter stocks to date and they are concerned. In 2014, end users lived through some truly awful numbers, with butter hitting $3.08/lb on the spot market in early fall. This was all predicated on abysmally low stocks built in the first half of the year. While we are nowhere near those levels, butter inventories are not rebuilding as sufficiently as the market feels necessary.

February's USDA cold storage report stated a total of 184 million pounds in stock, which was up 3.9% from the previous month but down 3.9% year over year. This is a particular concern, as the previous year was not positive. This news must be linked to the fact that we are approaching the summer, when cream will begin to divert to ice cream production. In addition, California's drought is negatively impacting milk production. It's a recipe for high second half future prices.

Going Forward in the US

We do not see the current conditions changing in the near future. We expect plenty of milk worldwide keeping prices in check. Unless the Russian embargo is lifted or China jumps back into the market, demand will remain mediocre at best. California water concerns will continue into the summer, potentially depressing even more the milk production potential. Additionally, if the currency imbalance continues and the dollar remains strong, we will continue to lose in the important export market.

We expect the very slow but steady decline of the whey market to continue. The WPC market has fallen substantially and processors are seriously considering moving their whey solids away from protein and into the whey pipeline. Let's face it, if you need to store product, it's better to store 50 cent whey versus $2.70+ WPC 80.

Again, unless China re-enters the market, the NFDM/SMP market will remain depressed. European SMP production and a favorable exchange rate will continue to keep the EU in a position of favor when it comes to the world market. We are ramping up production as we enter the flush and stocks will continue to grow. The situation in California will continue to be a potential barrier to substantial inventory growth, but prices are expected to remain flat. The one exception will be high heat nonfat, as its inventories may lag while processors focus their efforts on low heat to clear incoming milk supplies.

We see no reduction in the price of butter from here into the summer and early fall. Weak milk production in the West, where the bulk of the US butter is made; summertime cream shift away from the churn; and lackluster cold storage stocks all point to possibly growing prices.