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Australian Beef: On the Cusp of Great Things

Production, Exports and Prices Looking to the Future

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Contents

- **Given the recent record years for Australian cattle slaughter, herd inventory and production are expected to drop significantly in the coming years.**
- **Of the major export markets, China is expected to see the most opportunity for growth with the implementation of the free trade agreement (FTA), while exports to the US are expected to ease as their herd and productive capacity rebuilds.**
- **In live exports, the Indonesian market is expected to remain strong, pending any potential political influences and quota setbacks, while the Vietnamese market is seen as a strong growth prospect.**
- **Based on the strength in global markets, the indicative Australian cattle price (EYCI) is expected to trade in a range between AUD 5/kg and AUD 6/kg cwt range over the next 12 months, 40 percent to 70 percent higher than the five-year average.**

Introduction

The outlook for the Australian beef industry is extremely bright, notwithstanding ongoing climatic challenges in some regions. Global fundamentals in the red meat sector indicate constrained supply from major exporting countries in the midst of strengthening demand. Australian beef producers are expected to benefit from these positive global fundamentals, while also gaining additional competitive advantages from a strong US dollar, recently achieved trade agreements and an influx of capital opportunities. As always, weather will be a critical factor in the industry's and individuals' abilities to capitalise on these strong market opportunities.

With a generally optimistic sentiment flowing through the industry, common topics of discussion are focused on domestic production, export markets, the live cattle trade and the future for cattle prices.

Production cannot continue at these levels

- **With cattle inventory estimated to drop to 26 million head, a sustainable slaughter rate is expected to be found between 7 million and 7.5 million head per year, a decrease of about 2 million head on 2014 levels.**
- **An increase in slaughter weights will partially offset the reduction in slaughter numbers; however, production is expected to drop to between 2 million to 2.17 million tonnes.**
- **The Australian beef industry's rebuilding process is expected to be relatively slow, given the high slaughter rates of female cattle and magnitude of slaughter numbers.**

Record slaughter numbers have enabled the industry to tap into growing and lucrative export markets; however, production at this rate—given the herd size—is not sustainable. Slaughter rates above 8 million head and live exports over 1 million head cannot continue, given estimated herd numbers. The breeding herd is not being replaced, and this will lead to an increasingly rapid reduction in cattle inventory and future production capacity.

While cattle inventory numbers could potentially under-represent the actual numbers of cattle on farm, the estimated cattle inventory of 26 million head for 2016 is expected to produce a sustainable slaughter rate of between 7 million and 7.5 million head per year. Given slaughter rates of between 8.3 million and 9.2 million head for the last two years, for the industry to stabilise, annual slaughter rates will have to drop by 1.5 million to 2 million head. Such a reduction in slaughter will have consequences in Australia's ability to meet export and domestic market demand, as well as within the industry, with the possibility that assets become underutilised.

Despite the inevitable slowdown in slaughter rates, strong export markets and higher prices across all categories provide incentives for producers to continue to produce more kilogrammes. Higher turnover and higher cattle weights encouraged by these strong markets may mean that the normal reduction in production associated with a herd rebuilding phase—with lower slaughter numbers and the retention of breeding cattle—may not be as dramatic as in previous years. The existing and forecast higher prices will encourage higher average slaughter weights—up around the 290kg mark, compared to the five-year average of 280kg—suggesting that production will be in the range of 2 million to 2.17 million tonnes. While this is still a considerable reduction in production—dropping from 2.54 million tonnes in 2014—it is potentially less pronounced than if strong export demand and prices were not in play.

The herd rebuilding process is expected to be relatively slow, given the large slaughter rates and, in particular, the high female cattle slaughter. Since January 2014, females have made up 51 percent of the total slaughter, compared to the average monthly rate of 43 percent in 2011, when the national herd was growing. Such high volumes of females in the total slaughter numbers and the impact this will have on the breeding capacity suggest that rebuilding the herd will be a prolonged process.

Beef export markets

- **Despite the level of exports to the US being historically high, they are not unique, and as US beef production recovers and trade environments change, the level of exports to the US is expected to decline. But opportunities exist for Australian beef to leverage characteristics and support developing niches of the US beef consumer market.**
- **With improved access under an FTA—coupled with strong credibility to meet the needs of the food safety-conscious Chinese consumer—China has the potential to become one of Australia's top two beef trading partners.**

With a potential drop in production of 500,000 tonnes, export and domestic markets are going to face supply pressures, given the volumes that they have become accustomed to in the last two years. Given a stagnating domestic demand, exports provide the growth markets of the future, yet price and supply issues influence competitiveness into these markets and put pressure on Australia's longer-term ability to secure these markets. The challenge for Australia in the future will be to retain access to growing export markets and ensure that—once the Australian production levels return to a more sustainable level—the industry can continue to benefit from these markets.

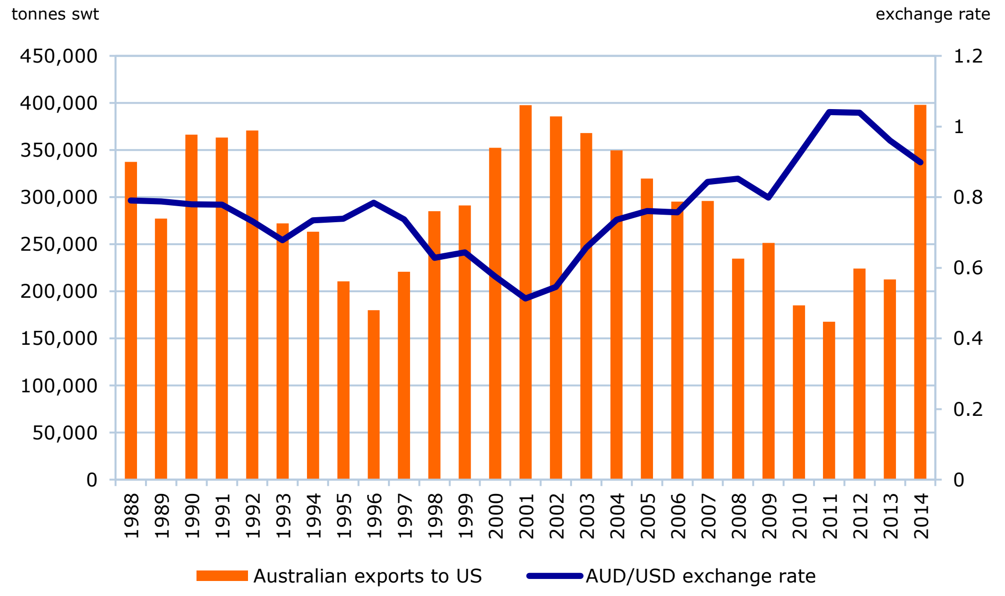
The US and China, in particular, have played an important role for Australian exports in recent years and are set to play a continued role, albeit with different opportunities. In 2013, China imported an additional 179,307 tonnes cwt, absorbing much of the additional 205,569 tonnes cwt produced in Australia that year. Similarly in 2014, when an additional 229,359 tonnes cwt were produced in Australia, the US imported an additional 270,580 tonnes cwt. Australia's ability to supply into these two major markets in the coming years will have a major influence on the export earnings ability of the Australian beef industry.

US

A number of coinciding factors have made the US market particularly valuable for Australia in the last 18 months; however, despite the level of exports being historically high, they are not unique. Severe liquidation of the US herd to a 35-year low, followed by record prices for US beef and a subsequent depreciation of the Australian dollar, were all factors that contributed to the US taking the title as Australia's largest beef export market in 2014, increasing 86 percent YOY, to 396,698 tonnes swt. But similar export volumes were experienced in 2001 and in the early nineties. In both cases, the high export levels were followed by a gradual easing in exports. A similar trend is expected off the back of this latest peak in export demand, given that current exports to the US are, to a large extent, filling a short-term gap in the US production system. As those factors that have worked in Australia's favour start swinging back the other way, the industry needs to plan for the inevitable gradual decline from these lofty heights.

The large liquidation of cattle from the US suggests that the US herd rebuilding process will be prolonged—five to ten years—and while this is the case, Australian exports to the US will remain strong, albeit at slowly declining levels. However—despite herd numbers and production capacity suggesting long-term demand—this will require favourable exchange rates. There is a strong relationship between the level of exports and the exchange rate, and based on the last 15 years, directional changes in the exchange rate are a strong signal to directional changes in exports to the US *(see Figure 1)*. Any matter that affects the relative strength of the two economies and results in an appreciation of the Australian dollar could facilitate a more rapid reduction in exports to the US.

Figure 1: Australian beef exports to the US, 1988-2014



Source: Australian Department of Agriculture, Reserve Bank of Australia, 2015

Despite the economic and production factors driving the current increase in US beef imports, the future US demand for Australian beef is going to be heavily influenced by an underlying change in how US consumers eat their beef. The US consumer's appetite for burgers is increasing, and within that, the premium burger service industry continues to capture a growing market share. By capitalising on the increased awareness and demand by consumers for quality—along with the advent of products such as organic, grass-fed and hormone-free—US food service operators are seeking out supply chains that can provide these products, and Australia is well-placed to meet this demand. Good examples include the announcements in late 2014 and early 2015 by the Chipotle chain, which is sourcing Australian beef to meet its 'grass-fed' product line, while the Carl's Jr. burger chain is sourcing Australian beef for its 'all-natural' burger.

This increase in burger consumption and change towards premium burger chains will provide a double benefit for Australian beef exporters to the US. Firstly, it encourages continued demand for ground beef, which lifts the price of the lower-value, yet high-volume component of a carcase and in turn lifts the whole carcase price. This is particularly important, given that the US is Australia's largest market for manufacturing beef. Secondly—and possibly most importantly for the Australian industry—the quality focus of the consumer provides opportunities for the Australian beef sector to capitalise on the intrinsic characteristics of the Australian beef production system that meet these new consumer demands. However, setting up supply chain arrangements, developing industry standards and developing quality assurance programmes that support such systems will be critical to the long-term credibility and marketability of such traits.

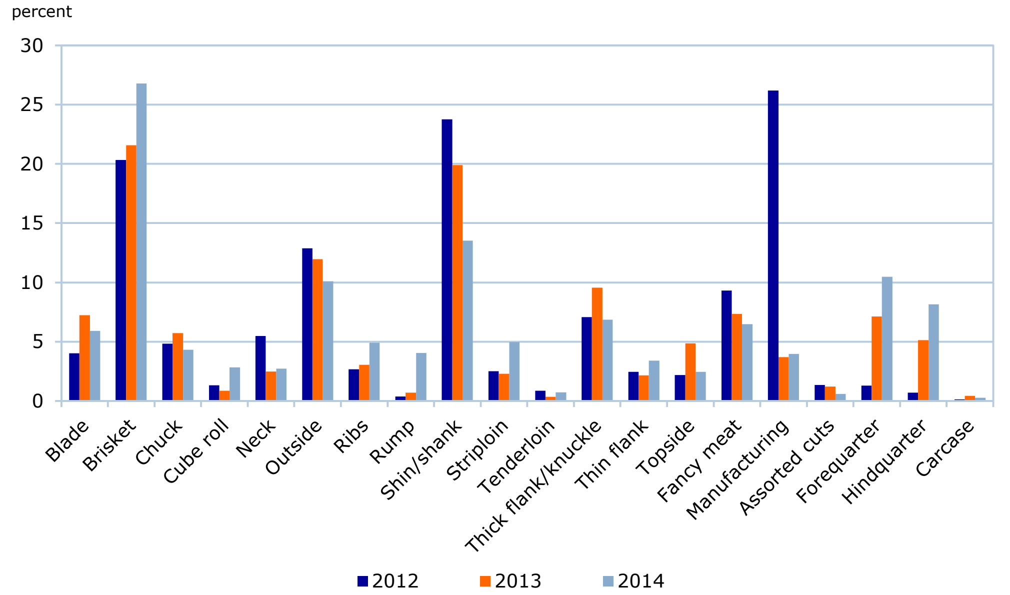
China

China exploded onto the Australian beef export scene in 2013, and while the same growth has not been evident in 2014 and into the start of 2015, over the longer term, it has the potential to become one of Australia's top two beef trading partners. Current major trading countries Japan, South Korea and the US, while nonetheless very important, all have limited growth prospects. China, on the other hand, is a relative newcomer as a world beef consumer. With low, but growing per capita consumption, strong economic growth and increasing wealth—coupled with a huge population—even small increments in consumption can shift the needle in total demand for beef: a positive for all beef exporters in the world. In addition—and in areas that particularly suit Australian beef production—is the increased consciousness of food safety and nutrition by the Chinese consumer. Indeed, increased beef consumption and food safety are both being promoted in the Chinese food and nutrition development programme out to 2020.

Chinese sales of beef and veal are currently experiencing the strongest growth of any meat, at 4.8 percent (CAGR from 1996 to 2014). Rabobank expects the growth in consumption to decline slightly, to 2.2 percent (CAGR over the next decade), due to a slowing of the economy, although it is still expected to grow faster than other meats. Such growth rates translate into demand of an additional 2.2 million tonnes per year over the next ten years—or approximately equivalent to Australia's total annual production. At the same time, China's domestic production is not expected to keep up with this increased demand, providing continued and increasing demand for imported beef.

China is a relatively young market for large-scale exports from Australia; however, trends are already developing in the particular types of cuts and beef being exported to China from Australia, reflecting changes in consumer trends. The three major primal cut groups that make up a large proportion of exports to China are the brisket, outside and shin/shank cuts typical of Asian cuisine quick service and the hot pot food service industry *(see Figure 2)*. In 2014, China was Australia's biggest market for shin/shank cuts and second-biggest market for brisket behind Japan. However—reflective of a greater focus on western-style red meat consumption and increased exposure to beef and western eating habits through steak house-style restaurants—the ribs, rump, striploin and tenderloin cuts all saw positive growth YOY in volume terms between 2012 and 2014.

Figure 2: Composition of Australian beef exports to China by primal cut, 2012-14



Source: Australian Department of Agriculture, Rabobank, 2015

Australian export figures to China show a growing proportion of beef traded as forequarters and hindquarters. While reflecting some of the advantages with reduced processing costs for boning in China, this poses a question to Australian exporters seeking to establish an identity in China—whether as individual companies or under the 'brand Australia' banner. The large majority of beef currently sold at the retail level is through markets in a non-branded form, supporting the export of quarters or carcases where they can be broken down and distributed in-market. However, with growth in other retail forms—such as supermarkets and, more importantly, through online and e-commerce platforms—greater opportunities for branding become possible, and as such, the ability to capture more value from the supply chain. Developing in-market or supply chain agreements will be critical to accessing this additional value.

Adding to the prospects for the Chinese market of becoming Australia's most important trade destination is the FTA waiting in the wings. Aside from New Zealand, no other major beef-exporting country currently has an FTA with China, which, once enacted, will eliminate the current 12 percent to 25 percent tariff over nine years. Official access—and at a reduced tariff rate—provides Australia with a significant advantage of targeting the high-end food service and retail operations, where most value can be obtained.

Live cattle markets

- **The Indonesian market is set to remain the primary market for live cattle exports, with a medium-term export volume of 700,000 head to 800,000 head per year; however, political influences will be the major impediment to faster development in the trade.**
- **Vietnam is showing promise of becoming the next strong live export market; however, the pace of development will need to be managed to accommodate requirements for animal welfare and short-term supply constraints.**
- **While the US may provide a short-term market opportunity with current market conditions, China provides a much bigger opportunity longer-term, although it will require infrastructure investment to accommodate such a trade.**

2014 was a record year for live cattle exports, with exports of 1.3 million head to major destinations such as Indonesia (736,312 head) and Vietnam (166,970 head) growing by 61 percent and 148 percent, respectively. Opportunities exist for the live export trade to increase further, with markets such as Indonesia set to consolidate and Vietnam expected to grow; however, Australia's ability to capture these opportunities will be constrained by the availability of cattle.

With the number of Australian cattle available for live exports expected to be reduced significantly, particularly in Queensland, competition between live export destinations and Australian production of boxed beef will increase. In a supply-constrained environment, producers and exporters need to be cognisant of the longer-term operations and opportunities in markets, rather than short-term financial gains. Just as a seasonal fluctuation can restrict Australia's ability to supply a region, so too the volatility in export markets can mean that they are reduced or closed at short notice. Goodwill will need to be exhibited by all parties to retain secure, stable trading operations.

Indonesia

The Indonesian demand for live exports is set to continue, and it is expected to remain the primary destination for Australian live exports into the foreseeable future. As in many other Asian countries, Indonesia's large, growing population, increasing wealth and decreasing domestic beef production lend themselves to an increasing demand for imported beef in live or boxed form. Furthermore, in the case of Indonesia, the established live cattle trade and stock feed availability support continued live export trade. But political interference is a regular occurrence in this market and leads to uncertainty, creating a more cautious expansion approach within the industry. While physical capacity to increase further remains within the Indonesian live cattle trade, until the political instability is resolved, incentives to increase the trade remain subdued.

Political interference aside, 700,000 head of live cattle could become the new normal for Australian live exports to Indonesia in the medium term, with progressive growth to meet the growing demand and any shortfall in domestic production. The stability in the Indonesian wholesale price for beef during 2014 suggests that supply of around 700,000 head could be a point at which supply of live cattle matches the demand for beef. The wholesale price only increased 5 percent between February 2014 and June 2015, except for a few small peaks associated with higher demand during Ramadan. In comparison, the period between Q1 2011 and Q1 2014 saw prices increase 45 percent, as annual exports went from 413,789 head in 2011 to 454,152 head in 2013.

The Indonesian trade may be shielded slightly from any reduction in Australian cattle numbers, given that the majority of cattle are sourced from the Northern Territory, where the seasons have been average, or even above-average, in recent years. But Indonesia will need to be able to compete with other growing export markets. New live export markets in the South-East Asian region are adding price competition for the reduced supply of Australian cattle, with a number of other South-East Asian markets (e.g. Vietnam) currently paying higher prices for cattle. Australian suppliers also need to be cognisant that rapidly escalating prices may force Indonesia to look elsewhere, and it is imperative that the live export industry strengthen its ties with this major trading partner—reinforcing the animal health and economic factors that support the trade, along with the capital investments and business partnerships that are evolving—in order to tie the two countries closer together.

Other South-East Asian markets

The last couple of years have seen growth and new prospects for potential growth in other South-East Asian countries such as Vietnam and Cambodia. While some of these countries act as an access point for beef travelling into China, they are also consumers of beef in their own right.

Of the countries in South-East Asia, Vietnam shows the most promise. Beef plays an important part in the Vietnamese diet, with per capita consumption greater than in any other South-East Asian country, at 6.97kg, making up 14 percent of the meat consumption (excluding seafood) in the diet (*see Box 1*). With general increases in wealth, per capita consumption is forecast to increase to 8.5kg in 2023, and—together with population growth—this equates to an additional 231,000 tonnes of beef, or approximately 850,000 cattle. Furthermore, domestic cattle production is showing signs of declining after peaking at 293,000 tonnes in 2012, and the ability to source suitable stable supplies from other parts of Asia is limited.

Australia is well placed to capture some of this increased demand. With the establishment of the ASEAN-Australia-New Zealand Free Trade Area (AANZFTA), the current 5 percent tariff on live cattle trade is due to be reduced to zero in 2016. This should add to the competiveness of Australian cattle with other Asian countries. In addition, despite Vietnam offering higher prices than Indonesia, imported live cattle can be sold by Vietnamese operators cheaper than domestic beef in local markets—something that should become easier with the removal of the tariff. A challenge for Vietnam, however, may lie in the ability to feed a growing live cattle industry, given that domestic crop production is currently heavily geared towards and increasingly focused on rice production.

But as it is a new market, caution must be exercised when it comes to the speed of development in Vietnam. Issues have already arisen surrounding animal welfare protocols, and there is the potential to oversupply the market, depressing prices or giving rise to negative attitudes of local producers. Allowing time for the market to develop—including any welfare requirements and capital investment—will support a more stable long-term market.

Box 1: Indonesia and Vietnam—a comparison

Indonesia	Vietnam
Population: **250 million**	Population: **90 million**
GDP per capita: **USD 3,475**	GDP per capita: **USD 1,910**
Beef consumption per capita: **1.66kg**	Beef consumption per capita: **9.69kg**
Domestic beef production: **479,000 tonnes**	Domestic beef production: **402,000 tonnes**
Beef consumption: **607,000 tonnes**	Beef consumption: **1.2 million tonnes**
Beef imports: **129,000 tonnes**	Beef imports: **890,000 tonnes**

Source: OECD, FAO, World Bank, 2015

The US and China

China draws a lot of attention as a major, growing consumer of beef, and with the recent signing of a live cattle trade protocol by the Australian government, the prospect of establishing a live cattle trade looks good. However, despite China currently importing significant numbers (118,027 head in 2014) of Australian live breeder cattle (predominantly dairy cattle), to date, there has been no live slaughter or feeder cattle trade. Therefore, the establishment of such a trade will require infrastructure investments to accommodate the large numbers of cattle that would make such a trade viable. Feedlots are small and fragmented, with the majority located in the Shandong and Henan provinces. Most of the large processing facilities are not located near coastal shipping ports, thus requiring transport infrastructure investment. But China does have the ability to use and process the whole beast—from meat cuts through to offal and hides—allowing them to utilise the full value of the animal if it were transported live.

Opportunities to export live cattle into the US are physically possible, but economically questionable in the longer term. The US has a track record for importing live cattle, and so the physical aspects of establishing a trade are sound. Live cattle are regularly imported from Canada, Mexico and Hawaii, and the US has the facilities to accommodate live cattle transport by boat. While US cattle inventory is at 35-year lows, US prices are at record levels, and there is a favourable exchange rate, a live trade might be feasible. However, it is difficult to see the market developing into a significant long-term live cattle market for Australia, given these stars do not align regularly.

Where to for cattle prices?

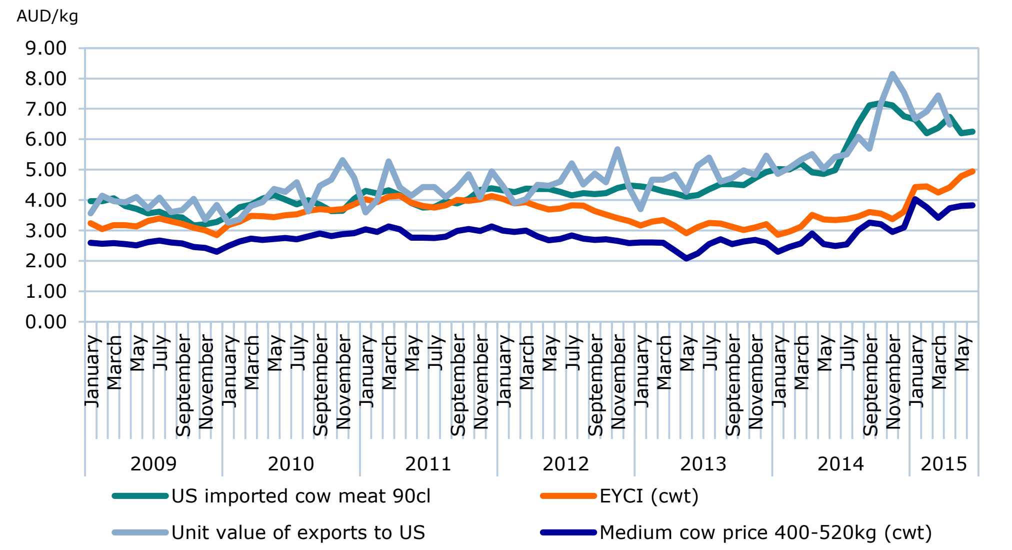
- **Based on the strength in global markets, the Australian Eastern Young Cattle Indicator (EYCI) price is expected to trade in a range of AUD 5/kg to AUD 6/kg cwt range for the next 12 to 24 months.**
- **Australia has the ability to capitalise on potential value-added characteristics and gain greater access to more markets in a supply-constrained environment in order to support ongoing export demand and higher prices.**

In 2015, Australian cattle prices started strongly. They have increased and are expected to remain strong for the remainder of the year and into 2016. Initially, prices were expected to react to a shortening in supply, as either seasonal conditions improved or herd liquidation eased. However, with slaughter rates 3.8 percent higher in the first five months of 2015 than the same period in 2014, we have not seen the expected reduction in supply, and prices have been driven by global demand, fuelled by a strong US market.

US cattle prices—as the major driver of current domestic prices—are a good indicator of what the near-term future price for Australia might be. In 2014, the price of lean manufactured beef (90cl ground cow beef) increased from AUD 4.77/kg to AUD 7.42/kg. While it has tempered in the first half of 2015, it still remains 37 percent above the opening price in 2014 (*see Figure 3*). In 2014, manufactured beef made up about half of the total beef exported to the US and about 6 percent of Australia's total production. Understandably therefore, the domestic Australian cattle prices follow a similar trend to the US 90cl price. Through 2013, due to the large numbers of cattle being slaughtered in Australia, the US 90cl and Australian cattle prices drifted apart. Since late 2014, Australian prices have started to increase; however, they still lag behind US prices. After a rise in late 2014, US prices have come back, although an appreciating US dollar has insulated the Australian market from the full extent of the reduction. With Australian prices continuing to rise and US prices stabilising, they are set to meet again and return to a more normal relationship within the AUD 5/kg and AUD 6/kg cwt range.

With large price increases already accommodated within the market, it is not expected that further price increases fuelled by restocker demand will be as dramatic as in previous seasons. In the last three droughts, prices increased—from the bottom of the market to the top—by 154 percent (1997-2001), 80 percent (2002-04) and 51 percent (2009-11). Applying these price increases to the market low of AUD 2.82/kg in 2013 would result in prices in the range of AUD 4.25/kg to AUD 7.16/kg. Prices above AUD 7/kg would place domestic prices at odds with US prices; however, applying these historic seasonal trends does match the forecast of between AUD 5/kg and AUD 6/kg, as outlined above.

Figure 3: Australian beef and cattle prices, Jan 2009-May 2015



Source: MLA, Rabobank, 2015

A range of factors will influence the ability for prices to reach these high levels and for such prices to be sustained. Tight global supplies and sustained global demand suggest these higher prices will be around for a number of years before any of the major beef-producing countries can increase production. In addition, there are a number of specific things that play in Australia's favour. Firstly, the US imported 90cl product (Australia and New Zealand beef), which normally trades very close to the US domestic product price, was operating at a discount of USc 45/lb in July, after coming back from an USc 82/lb gap in May. Changes to US country of origin labelling rules, sustained strong demand by US consumers and shortening of Australian supply could see this discount removed, transpiring into higher prices for Australian-manufactured beef without compromising the competitiveness with the domestically-produced product. Secondly, Australia has the ability to leverage some of the characteristics of the Australian beef industry and establish a price premium in export markets. Furthermore, current and improved access to a wide range of export markets through free trade agreements removes exposure to any individual market fluctuations and will allow the gradual reduction in exports to the US market to be transferred into growing China and Asian markets. Developing and seeking these improved demand situations will be critical to developing an industry based on a valuable product and not exposed to the more traditional seasonal volatility in prices. Unfortunately for the Australian consumer, however, the growing size and value of the export market will determine price movements in the domestic market.

Conclusion

The future of the Australian beef industry is looking bright. Key fundamentals for a strong Australian beef industry—consisting of strong international demand, constrained global supply, a depreciating dollar and trade agreements—are falling into place. An improvement in the weather and drought-breaking rains through many cattle-producing regions would provide that necessary relief for many producers and allow the herd rebuilding process to begin.

The Australian beef industry has long been exposed to the supply-and-demand fluctuations experienced by global drivers and local seasonal conditions. While depressed prices have been driven by short-term high domestic supply, the Australian industry is now in a position to capitalise on strong global demand, providing an opportunity to develop an industry with a premium, value-added product. This would ensure a more stable, long-term environment for the Australian beef industry.