Rabobank

Australia's Major Boxed Beef Export Markets

The Steaks Are Changing

Rabobank International

Food & Agribusiness Research and Advisory

Global Animal Protein Sector Team

Sarah Sivyer
sarah.sivyer@rabobank.com
+61 2 8115 2368

www.rabotransact.com

Contents

Throughout 2012, Australian boxed beef[1] exporters have faced hurdles in the two key export markets of Japan and Korea. As a result, exports to both Japan and Korea are down 7.5% and 20% respectively year to date. Australia competes aggressively with the United States (US) in both of these markets for market share.

Dynamics in these markets are expected to change moving into 2013. While competition from the US in both Japan and Korea will continue, it will be in a limited capacity as the US faces reduced production levels and as a result, reduced ability to export. On top of this, in Korea, government slaughter incentives will result in increased production in 2012 and at the beginning of 2013 but this will then subside creating opportunities for exporters to begin to move product again.

Tight supply in Australia's third key export market, the US, will continue into 2013/2014 as the US begins to rebuild its herd. This will continue to create opportunities for Australian producers.

Introduction

In 2012, the strong Australian dollar combined with an aggressive US marketing campaign has continued to see US product displace Australian beef in Japan. This should be seen to a lesser extent in 2013, as US production will be down between 3 percent and 9 percent leading to reduced availability of product for export into this market.

In Korea, a surplus of domestically produced 'Hanwoo' beef has reduced imports from all countries. In 2012, the cyclical trend of increasing herd size followed by government incentives to reduce numbers and support prices should have reached its peak with domestic production expected to subside in 2013. This will provide opportunities for importers to regain some exposure.

In 2011, total exports from Australia and the US into Japan and Korea equated to 460,000 tonnes and 270,000 tonnes, respectively. This is differentiated from the 170,000 tonnes that Australia exported to the US in the same year.

The worst drought in over 50 years has left the US with extremely tight supplies, converting it from a net exporter to importer in 2013.

Even with the benefit of a weaker currency, rising beef prices because of increasing input costs and significantly tighter supply will also reduce its export competitiveness.

Australia, with its increasing production levels, is very well positioned to meet global demand, particularly given the contracting beef supply elsewhere.

The battle for Japan

Beef exports from the US are capturing market share from Australia in the increasingly price sensitive Japanese market. Australian beef exports to this key market have fallen 7.5 percent year-to-date and are tracking 13 percent lower than the five-year average, while Japanese beef imports from the US have jumped 5 percent in the past year. Despite some recent month-on-month improvements, reduced competitiveness due to a strong Australian dollar, aggressive US marketing, and price sensitive consumers in the Japanese markets have combined in a major shift in demand away from Australian beef in 2012. Australia's

[1] The term boxed beef is distinct from live exports sent from Australia. Live export is an important trade for Australia, accounting for close to AUD 630 million in exports in 2011. This trade is not discussed in this note with any reference to beef.

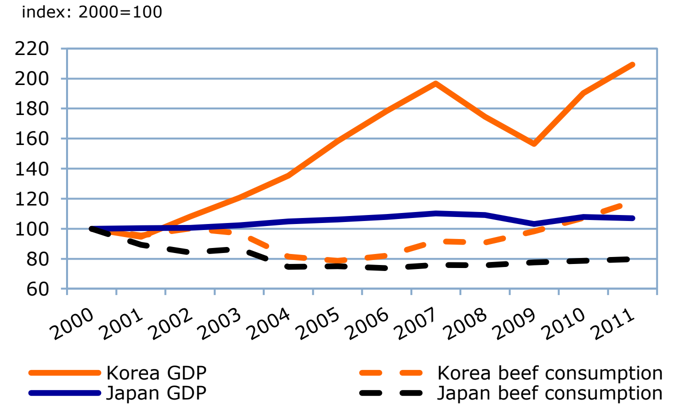
currency is expected to continue to remain strong throughout 2013, sustaining the challenging environment for Australian exporters.

In addition to currency issues, beef imports into Japan are also competing with strong domestic production. Year-to-date figures show that domestic production has increased 5 percent on 2011. This is largely a result of Japanese producers holding product back, waiting for confirmation that it was safe to send product to slaughter after the uncertainty of the Fukishima earthquake.

Japanese beef consumption in decline

The lingering cautiousness associated with the global financial crisis combined with the devastating effects of the 2011 Fukishima earthquake and tsunami saw significant disruptions to the Japanese food supply chain. These setbacks have affected consumer sentiment as well as consumption patterns. Korea has seen stronger GDP growth, and with that has come a quicker recovery in beef consumption relative to Japan (*see Figure 1*). The Japanese numbers also reflect the shock of the 2011 earthquake.

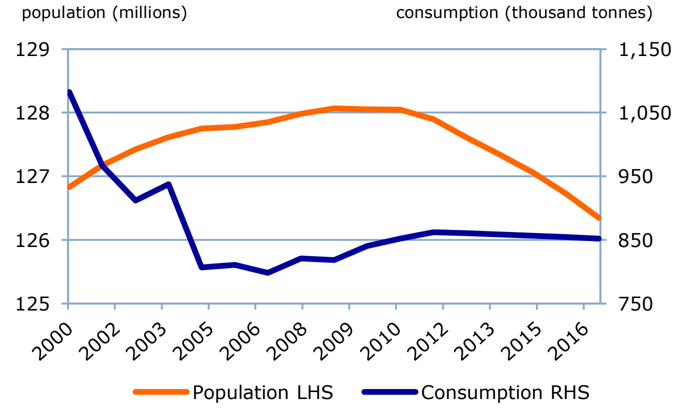
Figure 1: Growth in Japanese and Korean GDP and beef consumption, 2000-2011



Source: IMF, Rabobank, World Bank, 2012

The IMF is forecasting that the Japanese population has reached its peak and is now in decline. As a result of the declining population, beef consumption trends are expected to slow in the longer term (*see Figure 2*). It should also be noted that Japan's per capita beef consumption has never returned to the 2003, pre-bovine spongiform encephalopathy (BSE) highs of 9 kilogrammes per capita, and currently averages 6.5 kilogrammes. This is not expected to improve in the short term, particularly with poultry proving more cost efficient.

Figure 2: Japanese population growth and beef consumption, 2000-2016



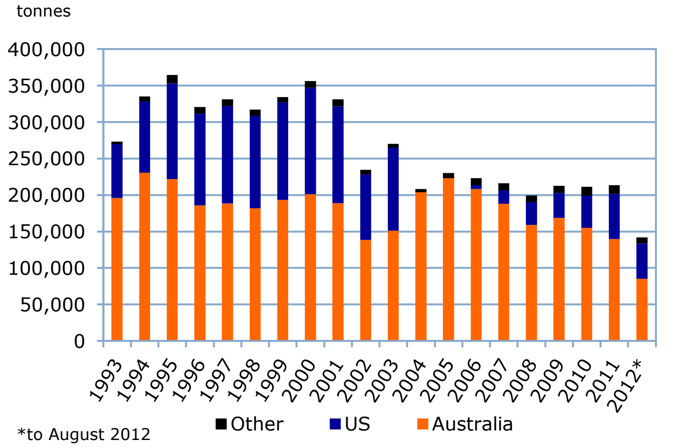
Source: IMF, Japanese Ministry of Finance MAFF, , Rabobank 2012

US pushing hard to regain stake in the market

The US is pushing hard to regain market share in the key Japanese beef export market and this is coming at Australia's expense. In 2003, Australia and the US had respective shares of the Japanese import market of 49 percent and 46 percent. In 2004, Australia's share jumped to 91 percent as a result of the US being forced to exit the market due to the discovery of BSE. In 2012, Australia's market share has been reduced to 62 percent as the US aggressively regains its share.

A closer look at the US beef market's push back into the Japanese market highlights the resurgence of the US in the chilled beef market *(see Figure 3)*. Since the beginning of 2012, Japan's volume of imported Australian product has declined 8 percent, while imports from the US have increased 24 percent. While the volume of US beef imports is increasing, it is still only half that from Australia.

Figure 3: Total chilled exports to Japan, 1993-2012*

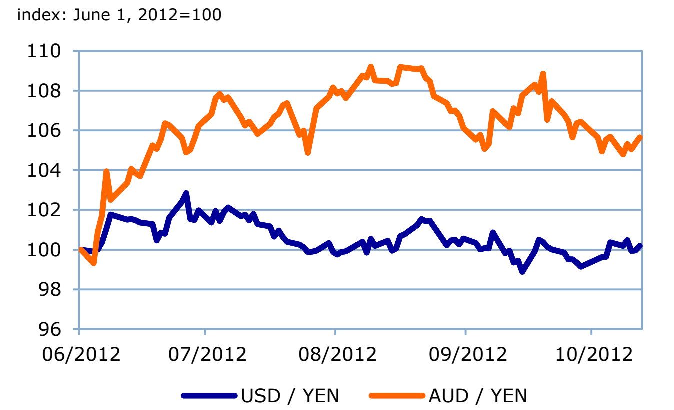


*to August 2012

Source: Meat and Livestock Australia, Rabobank 2012

The benefit of a weaker US currency is also obvious. In the last five years, the US dollar depreciated 33 percent compared to a 24 percent appreciation in the Australian dollar against the Japanese yen. Following the most recent round of quantitative easing (September 2012) by the US Federal Reserve, the Australian dollar has continued to gain strength against the Japanese yen, only adding to the pricing advantage that a weaker US dollar provides to US suppliers in the market *(see Figure 4)*. Rabobank FX forecasts indicate an expectation that the Australian dollar will remain elevated against the Japanese yen over the next 12 months, with a target of 86.1 at the end of 2013.

Figure 4: US and Australian currencies against the Japanese yen, indexed as of June 1, 2012



Source: RBA, Rabobank, US Federal Reserve, 2012

While the Australian currency has seen some relief against the Japanese yen in recent weeks, its strength will continue to affect exports to the Japanese market while the US currency depreciates. The upside to the current market situation is that beef prices in the US will continue to rise as a result of inflated grain prices and tight supply placing more upward pressure on export prices into the Japanese market. This will take some of the shine off the currency advantage.

Looking forward, the US is expected to continue try to make inroads back into the Japanese market, with 2012 expected to be its largest export year since before the BSE interruption. In 2013, the US will be limited by tight supply and as a result its resurgence into the Japanese market will be constrained by limited product available for export.

Rabobank believes that while Japan's Ministry of Health, Labour and Welfare has approved the lift in age limit for US imports into Japan from 20 months to 30 months, this will still need to be officially passed by government, and with an election date now tentatively set for December 16 the final decision on this policy may again be delayed.

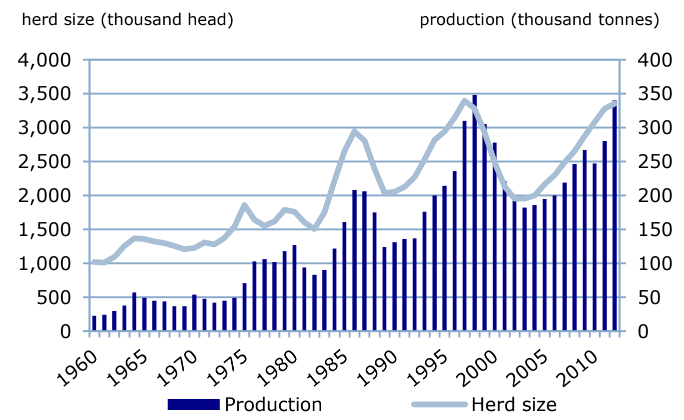
Should the increase in age limit be formally approved, Rabobank believes that this will not significantly affect the levels of US product entering the Japanese market. The increase in age makes more product available for US exporters to choose from and will reduce sorting time, however Japanese importers are already receiving as much product as they were demanding from US exporters.

In summary, the major factors affecting Australian exports to the Japanese market are longer term. The forecast for a strong Australian currency combined with the continued realignment of US product in the market will continue to make significant increases in Australian exports to Japan difficult. However, in 2013 the US will be constrained by tighter supply, lower production and increased export prices that will limit its export competitiveness, providing less competition for Australia. A scenario analysis including these factors and the impacts on Australian exports is included at the end of this report (*see Figure 13*).

Korean Domestic Supplies Displace Imports

Australian exports to Korea are down 20 percent but are likely to see some recovery in 2013. Over the last 10 years, the domestic beef herd in Korea has increased in size by 72 percent from 2 million to 3.5 million head. This cycle of increasing/decreasing herd size is not a foreign concept and is mostly driven by reactive government policy (*see Figure 5*).

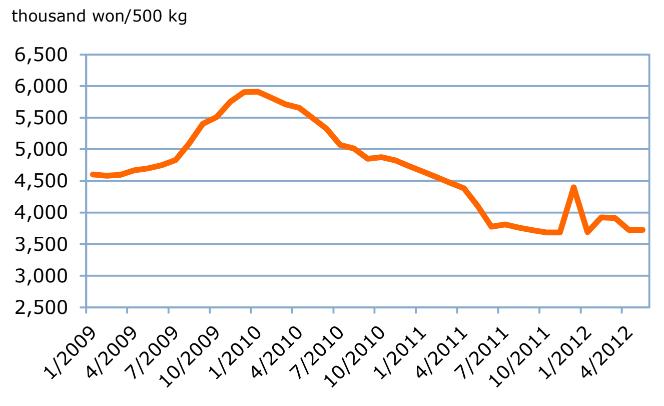
Figure 5: Korean herd size and production, 1960-2011



Source: USDA, Rabobank 2012

With an oversupply of cattle and with the government now intent on reducing this herd size, government financial incentives are in place to stimulate the slaughter of 'lower performing' cows. Due to recent lower cattle prices, farmers are self-regulating and reducing production (*see Figure 6*). In 2009, cattle prices increased as a result of constrained production levels. Prices peaked in 2010 then began to decline as the herd size continued to grow. Slaughter rates increased rapidly in late 2010 as Korea experienced an outbreak of foot-and-mouth disease (FMD). Since then, the oversupply of cattle relative to demand has seen prices fall 37 percent.

Figure 6: Korean farm gate cattle price, Jan 2009-Apr 2012



Source: Korean Meat Trade Association, Rabobank 2012

While production will increase in 2012 as a result of this increased slaughter, government incentives to reduce herd size combined with low cattle prices will lead to an expected slowdown in calf production moving into 2013.

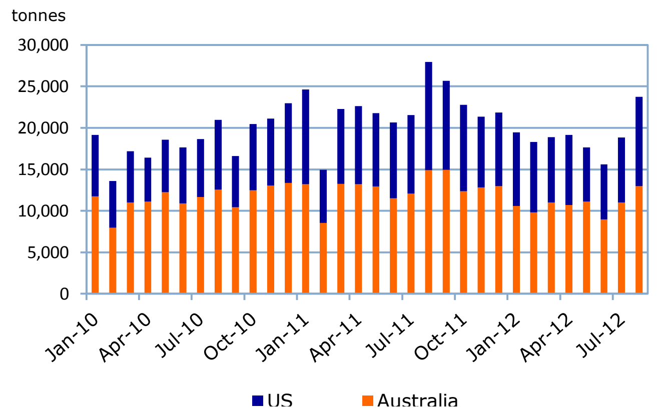
While Korean production mirrors Korea's cyclical herd size, improvements in carcase weight (20 percent increase over the last decade) have also led to improved production efficiency.

Both Australian and US imports down in 2012

The high inventory levels and low prices have created less demand for beef imports in Korea, with imports from both Australia and the US down more than 20 percent year to date. In fact, all countries that export into Korea are down relative to the same time last year, except for Canada, which only began exporting to Korea again in April of this year. To date in 2012, Australia's 50 percent share of Korean beef imports has not changed, while the US has increased its share from 37 percent to 38 percent.

In the last three months, Australian beef exports into Korea have seen some support as a result of increased demand prior to Chuseok, the Korean harvest festival *(see Figure 7)*, and more recently some cut shortages. Even with this increase, overall imports still remain down 20 percent year-to-date on 2011 figures.

Figure 7: Australian and US monthly exports to Korea, Jan 2010 - Jul 2012



Source: Meat and Livestock Australia, Rabobank 2012

Unlike the pork and poultry markets, which can see production turn around in months, the beef market production cycle takes years. With this in mind, Rabobank believes that Australian exports to the Korean market will begin to see some recovery as the Korean inventory begins to subside in 2013. However, similar to the Japanese experience, Australia is expecting strong competition from the US although US product will have limited availability and will also have increased in price.

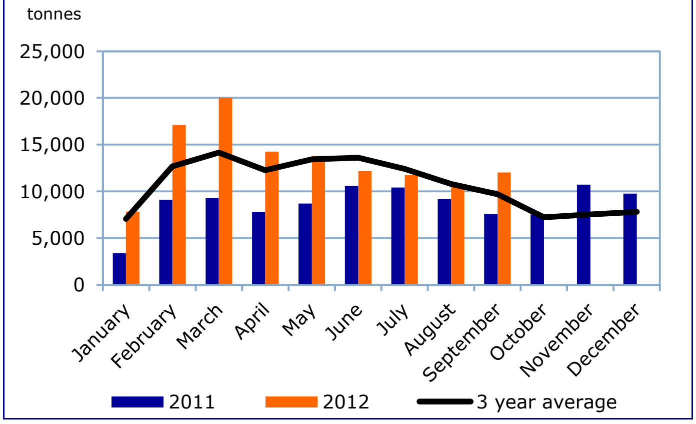
Moving forward, one source of differentiation between US and Australian exports to the Korean market will be the US-Korean Free Trade Agreement (KORUS FTA), where the 40 percent tariff on beef muscle meats imported from the US will be eliminated over a 15-year period. While the effects of the initial tariff reduction of 2.67 percent have been hard to separate from other variables, such as currency movements, the price gap between Australian and US product will become more noticeable when this tariff relief is increased to 5.3 percent in 2013. Assuming Australia is not successful in negotiating its own FTA in 2013, the gap will widen to 8 percent in 2014. While South Korea has built in volume protections to avoid a surge of US imports, it will be very important for Australian producers to ensure they do not put themselves at a competitive disadvantage in the market.

Bearing in mind the cyclical nature of the Korean domestic beef market, the aggressive realignment of US imports and the impact of the KORUS FTA, Rabobank believes that beef imports to Korea should see some support in 2013 as the effect of the Korean government's herd reduction incentives begin to take hold.

It's burger time!

The US has been the Australian beef industry's shining light, with Australian exports to the US up 40 percent year to date. This is mostly a result of increased demand for manufacturing beef (mostly used in hamburgers) which has been driven by a number of factors, particularly the lean fine textured beef (LFTB) issue (*see Figure 8*).

Figure 8: Australian manufacturing beef exports to the US, 2011-2012

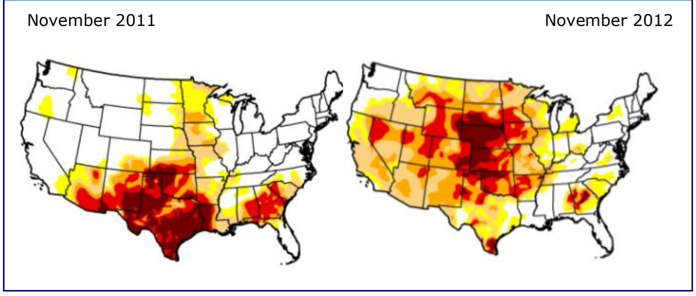


Source: MLA, DAFF, Rabobank 2012

In March 2012, the US was faced with the removal of the equivalent of 2 percent of their supply chain as the LFTB news broke. The Australian beef industry was quick to move and able to take advantage of the increased demand. It should be noted that while exports of manufacturing beef to the US are up 57 percent this year relative to 2011, they are only up 13 percent compared to the last three years average. In 2011, there was a significant decrease in demand for Australian manufacturing beef due to the liquidation of the US herd, which enabled domestic production to meet demand.

Along with the LFTB issue, the US has faced its worst drought in over 50 years. Unlike the drought of 2011, which was mostly limited to the key beef producing areas, in November 2012 more than 70 percent of the country is classified between abnormally dry to exceptionally dry by US Drought Monitor *(see Figure 9)*.

Figure 9: US Drought Monitor Comparison between November 2011 and November 2012

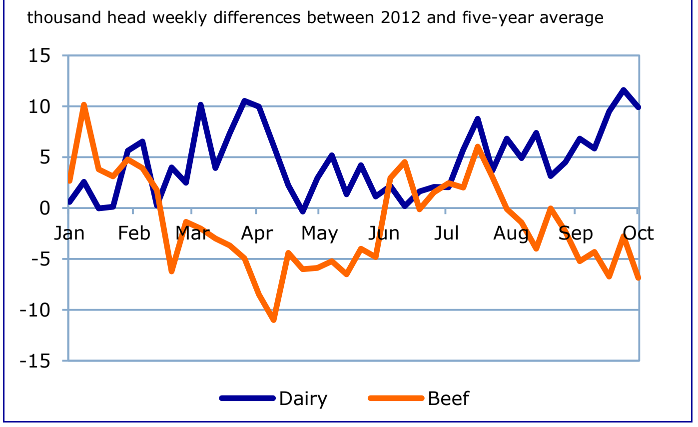


Source: http://droughtmonitor.unl.edu/archive.htm 2012l

Tight beef supply in the US leading to continued opportunities for Australia

Initial speculation was that tight beef supply in the US would lead to significant herd liquidation as producers ran out of pasture, leading to an acceleration of the already declining herd population. With liquidation speculation rife, the indicator that has been most interesting to follow throughout the last six months has been US cow slaughter. While total cow slaughter may be sitting above five-year averages, it is being driven by dairy cow slaughter rather than beef cow slaughter (*see Figure 10*). It is clear that the change in dairy slaughter has driven the overall increase in total slaughter numbers.

Figure 10: 2012 Weekly US dairy and beef cow slaughter numbers relative to five-year averages



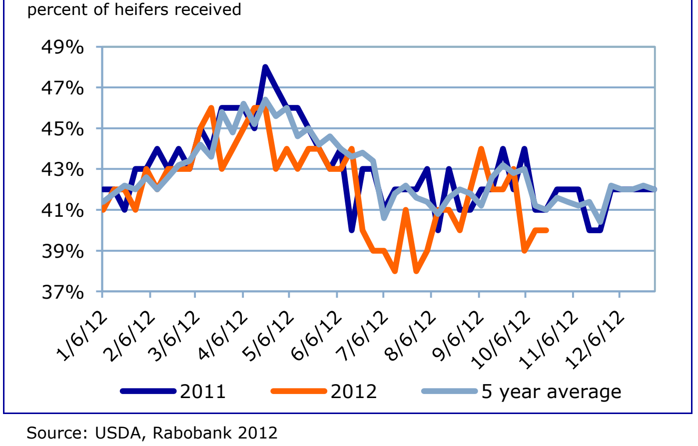
Source: USDA AMS, Rabobank 2012

Beef cow slaughter numbers are sitting well below the figures achieved in 2011 and are averaging 2 percent below five-year averages. On average, dairy cow slaughter has been 9 percent above five-year averages and has been driven by a lack of profitability in the industry. Corn and soybean prices rallying more than 40 percent earlier this year have also compounded the impact on dairy farm margins.

Other indicators of tight beef supply in the US include feedlot placements dropping to their lowest levels since the mid-1990s, creating an opportunity for Australia to meet this US demand.

When investigated further, the reduced feedlot placements highlight a significant reduction in heifer receipts, which is a good indicator that producers are trying their hardest to retain breeding stock for the coming years when herd rebuilding will be a priority *(see Figure 11).*

Figure 11: Heifers as a percent of feeder cattle receipts 2011-2012



Source: USDA, Rabobank 2012

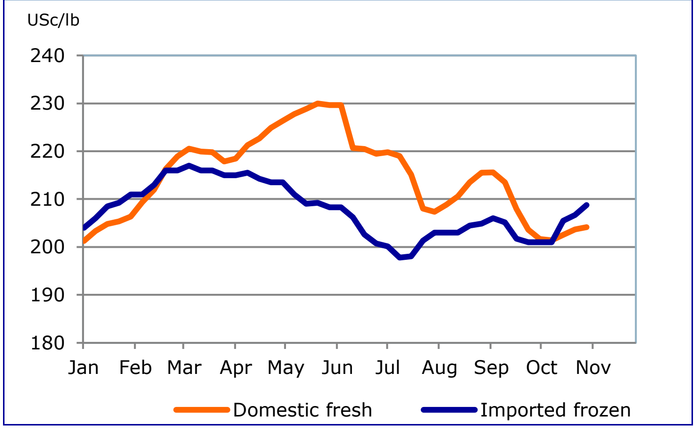
Looking forward, the recent spikes in feed grain prices are expected to be sustained through at least the first half of 2013, elevating domestic beef prices in the US over the same period. As most of the US herd is grain fed, compared with 34 percent of the Australian herd, this will provide additional opportunities for Australian beef in competing export markets such as Korea and Japan. Even with these impending input cost disadvantages, the US dollar will still play its part in ensuring that the US has a currency advantage.

Australia's Major Boxed Beef Export Markets

Australian beef will remain competitive as an import to the US market, particularly for manufacturing beef as record high manufacturing beef prices and the insatiable American demand for 40 billion hamburgers per year will help to sustain imports.

US domestic manufacturing beef prices had an extreme premium over imported frozen product throughout June and July 2012 *(see Figure 12)*. This trend has declined as a result of increasing US cow slaughter with the seasonal crest currently being experienced.

Figure 12:US domestic 90's and Imported 90's US East Coast Delivery Jan 2012 – Nov 2012



Source: USDA, Rabobank 2012

In October, imported product saw a price increase as a result of end users starting to book product out front and the fact that the imported product is already frozen, which adds a cost advantage over having to freeze domestic product.

Tight beef supplies and very strong prices will continue to support Australian beef exports to the US market. Assuming the drought recedes in the US, Australia is well positioned to meet what will be strong manufacturing beef import demand from the US over the next two years as the US positions itself for herd rebuilding.

Figure 13:Expected trends in Australian beef exports to key markets

2013	Japan	US	Korea
Production	Down 3%	Down 3% to 9%	Down 5% to 10 %
Per capita consumption	Down slightly	Down 2% to 5%	Up 2%
Imports	Up 2% to 3%	Up 15%	Up 5% to 7%
What does this mean for Australian exporters?	Opportunity for Australia to meet demand as US faces tight supply and rising export prices.	Exports volumes from Australia to the US to be sustained in 2013.	As Korean production recedes, opportunity for Australia to meet demand as US faces tight supply and rising prices.
Assumptions	**Japan** • Price conscious consumers switching between proteins resulting in decreased beef consumption and increased poultry consumption – driven strongly by the quick service restaurant (QSR) sector • US expected to continue to supply Japan with specific cuts such as short plate despite higher export prices as the US domestic market won't be able to compete on price • Domestic production has increased in 2012 but will decrease in 2013 as a result of decreasing calf crops **US** • US per capita beef consumption declining at 2% to5% • Herd rebuilding beginning as shown by producers retaining heifers • Tight supply expected for next 2-3 years (assuming drought conditions recede) • US will become a net importer in 2013 • High grain prices to be sustained into Q2 2013 • Increasing export prices as a result of increasing grain prices, tight supply and domestic demand will weaken competitive position in export markets • Carcass weights will reduce into 2013 (record highs in 2012) • Expect to see a mild and short lived negative impact on demand as a result of Hurricane Sandy **Korea** • Record slaughter numbers in October • Korean government incentives to reduce the domestic herd size will begin to take effect in 2013 **Australia** • Increased supply available in Australia which will put downward pressure on prices into the export market • Grass-fed product has a cost advantage in the current market environment • Demand for manufacturing beef in key Australian export markets is inelastic and will remain strong in these uncertain economic times as consumers choose cheaper cuts of beef • Australian per capita beef consumption is stagnant at 34 kg		

Source: MLA, USDA, Korean Meat Trade Association, MAFF, Rabobank, 2012

Conclusion

Australia will continue to face aggressive competition from the US in Japan and Korea as it attempts to regain lost market share. Rabobank believes this force will not be as strong in 2013 as the US will have limited product to export as a result of decreased production. The effect of tighter supply and increased grain prices will also reduce the US competitive edge through increased beef export prices.

Strong US demand for Australian product is also likely to be sustained in 2013/14 as the US begins to rebuild its herd and continues to face reduced production levels. The extent of the reduction in US production will depend on the weather. If it rains, then producers will retain heifers and production will be down at least 9%. If the drought continues, then the reduction in production is more likely to be closer to 3%.

While North East Asia is the current battleground for Australian and US product, it is likely that China will be next. October saw a major milestone achieved with export volumes from Australia to China for the month (7,524 tonnes) almost matching the entire volume for 2011 (7,754 tonnes), making China the fourth largest export market for Australia for the month. While these numbers are still half those of the third largest export market, Korea, it is critical for Australia to cement its position in the Chinese market given the opportunities that exist. Although the US does not currently have a formal agreement in place with China, it has managed to secure a market presence through Vietnam and Hong Kong.

Bearing this in mind, Australia remains highly dependent on its three key boxed beef export markets, with over 60 percent of exports flowing into them. This importance and focus is

Australia's Major Boxed Beef Export Markets

not expected to change in the medium term. However, emerging markets are increasingly important, now making up over 30 percent of Australia's export profile.

Rabobank International

Rabobank Food & Agribusiness Research and Advisory Global Animal Protein Sector Team

US—David C. Nelson
david.nelson@rabobank.com

Australia – Sarah Sivyer
sarah.sivyer@rabobank.com

Argentina—Paula Savanti
paula.savanti@rabobank.com

Brazil—Guilherme Melo
guilherme.melo@rabobank.com

EU—Gorjan Nikolik
gorjan.nikolik@rabobank.com

EU & Russia—Nan-Dirk Mulder
nan-dirk.mulder@rabobank.com

EU & Russia—Albert Vernooij
albert.vernooij@rabobank.com

Mexico—Pablo Sherwell
pablo.sherwell@rabobank.com

NE Asia—Chenjun Pan
chenjun.pan@rabobank.com

NE Asia—Jean-Yves Chow
jeanyves.chow@rabobank.com

SE Asia & India—Pawan Kumar
pawan.kumar@rabobank.com

US—Don Close
Don.close@rabobank.com

www.rabobank.com