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Rabobank Dairy Quarterly

Slow price ease from Q2 2014 still on the cards

Rabobank International

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- International dairy commodity prices were up on average 3% on opening-year levels in mid-March trade.
- Exportable supply rose strongly in Q4 2013 and into early 2014 as producers responded to improved margins brought about by high milk prices and falling feed costs.
- The increase in supply was more than matched by another extraordinary increase in China's purchases from the world market as Chinese processors continued to plug shortfalls left by declining local supply.
- Prices firmed yet again to ration demand among other buyers.
- China's purchases are expected to ease somewhat in the coming months as improved returns and dissipating disease bring supply closer to stability.
- A strong Northern Hemisphere production season, on the back of an exceptional season in the Southern Hemisphere, should generate more than enough exportable supply to exceed China's additional needs in 1H 2014, loosening the market somewhat.
- Rabobank expects this to result in an easing of pricing from mid/late Q2 2014.
- But the rate of price reduction will be limited by structural constraints on suppliers, the need to replenish depleted buyer inventories and ongoing demand growth in line with a slow economic recovery.

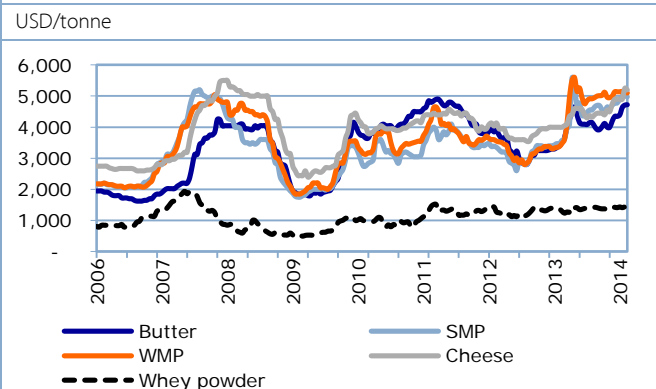
Prices

Dairy prices generally pushed upwards in international trade through January and February 2014. WMP was the exception, with prices slipping marginally over the period, bringing returns to this product line somewhat closer to those of other product streams.

March brought a small reduction in prices across most categories, a possible sign that the market is finally turning from the phenomenally high levels which have been in place for 12 months.

Global prices have so far proven resilient in the face of a recovery in milk production in export regions since July. Responding to high milk prices and falling feed costs, and blessed by generally excellent weather, producers in the Big 6 export regions boosted milk production by 3.7% YOY in the three months to January.

Figure 1: Dairy commodity prices FOB Oceania, 2006-2014



Note: Whey is FOB in western Europe

Source: Rabobank, USDA, 2014

With limited calls on additional product from the weak EU and US markets, after a lag, this product is now well and truly finding its way onto the international market. After a year of stagnancy or decline, outgoing shipments from key exporters rose by 11% in Q4, with momentum evident into the new year.

But like a dragon that just drinks more when supply improves, China raised its purchases from the international markets another level, more than accounting for the entire increase in exportable supply through Q4 and most likely through February too.

In a reoccurring nightmare for many importers, this has again left the rest of the buy side of the international market with less product to go round – and facing exceptionally high prices as the market seeks to ration supply.

More than 12 months of enforced dieting and the flow-on effects of high commodity prices are creating a difficult operating environment in many markets. Some markets face physical shortages, while most face significant retail price inflation.

Those being squeezed include not only hapless import competitors to China in regions such as SEA and the Middle East but also consumers in the West who now face a wave of retail price inflation in the dairy cabinet.

We have said for some time that the peak of the Northern Hemisphere supply season (April/May) and its aftermath will provide a major testing point for the resilience of current pricing.

With the Oceania season now largely sold, much depends on the relative strength of production growth in the European Union (EU) and the United States (US) versus the appetite of China, and how quickly other buyers will step in to soak up additional product once China's appetite is satiated.

Supply side

EU

- The alignment of good weather, attractive margins and easing quotas has continued to underpin strong supply growth in the EU.
- Favourable autumn weather was followed by an exceptionally mild winter, ensuring the production of good volumes of high-quality pasture and silage.
- This has reduced the amount of feed dairy farmers have needed to buy, combining with a gradual reduction in feed prices to reduce bills.
- Meanwhile, milk prices in the main producing regions reached more than EURc 40/kilogramme by the end of 2013, around 20% higher than same period of 2012, ensuring highly attractive margins for producers.
- With quotas again expanding by 1% for the current season, farmers have been able to respond to attractive margins and favourable weather by increasing production by 4.8% YOY in Q4 2013. Early data for 2014 suggests strong growth spilled into the new year. Growth has been strongest in the northern and western regions of Europe, where the weather was exceptionally bad 12 months prior.
- The rate of growth in some regions has seen milk supply exceed processing capacity a month or so before the season even peaks. While milk can be shipped to other regions within the EU for processing, this will weigh on returns to farmers in the coming months.
- As anticipated, consumption in the EU market appears to have stabilised in the closing months of 2013 and into 2014. While recent economic growth has yet been insufficient to create jobs, the volume of key products sold in many EU countries has stabilised or is growing slightly above the depressed levels of 12 months prior.
- Nonetheless, the recent strength of production volumes have provided EU processors with the capacity to boost exports for the first time in more than 12 months, with outgoing shipments up 4% in Q4 2013 in YOY terms.
- In the near term, the main risk to an equally strong finish to the 2014/15 season (which ends 31 March) appears to be farmers temporarily putting the brakes on supply growth to avoid overrunning their expanded quotas and thus incurring a super-levy (i.e. a penalty). However, in most countries where this is an issue, current milk prices ensure margins large enough to make it worthwhile to overproduce and pay the penalty.
- Rabobank expects EU production to rise by an impressive 4% YOY for 1H 2014, fuelling a surge in exports in the same period.

- As we enter the new quota year (2014/15), several factors are expected to limit growth below recent levels.
- We are unlikely to see a repeat of the near perfect weather conditions enjoyed by EU farmers over the last nine months, ensuring that matching prior year yields will be a challenge.
- As the final year before quotas are fully eliminated, under agreed EU policy, farmers will see no quota increase. Assuming some softening in margins, farmers will be less willing to exceed these quotas and just pay the penalty as some will do in the 2013/14 year.
- Rabobank believes that these factors will slow growth in EU milk production to 1% in 2H 2014.
- Assuming fractional growth in the EU dairy market, this will see the EU with sufficient supply to boost exports again in 2H 2014, though much less than in the prior six months.
- The game changes in 1H 2015, as we see quotas eliminated once and for all, enabling the EU to again make a substantial contribution to boosting internationally traded supply, albeit still affected by non-quota constraints.

US

- As anticipated, the US supply response to improved global market signals is lagging that seen in the EU.
- Milk prices reached an all-time record in February, with the All Milk prices likely to come in 25% up YOY in March.
- Plunging prices for corn and soybeans have reduced feed costs by around 25% over the same period.
- These factors combined have driven income over feed costs (IOFC) up by a staggering 120%, with the futures curve indicating a sustained period of positive margins of at least 12 months.
- Milk producers in California are capitalising on higher prices to push milk production well above last year's depressed levels (up 4% in January YOY). But poor quality forage and bitter cold from the 'polar vortex' have depressed production in the Midwest (down 2.4% in January YOY). National milk supply was up just 1% in January as a result.
- The domestic dairy market itself has required little additional milk in recent months, with the reduction of social welfare programmes offsetting the benefits of incremental employment growth.
- But the global market has been screaming for additional product, enabling the US to boost exports by 43% above prior year levels in Q4, and another 23% in January.
- In order to supplement weak supply growth, export orders were partly filled through the biggest drawdown of commercial inventories in more than a decade through 2H 2013.
- While IOFC is likely to narrow somewhat from the extraordinary levels currently on offer, Rabobank expects margins to remain attractive for US producers through 2014.
- Californian production will remain well above prior year levels, though growth will be crimped somewhat by a drought-induced increase in forage costs. Production in the Midwest will gradually rise above prior year levels in the coming

months, with the end of frigid temperatures (from now) and improvements in feed quality with the first cuts of hay in April/May.

- The second half of 2014 will therefore bring stronger supply growth (up 3% YOY) than 1H (up 1.7%). We continue to believe that even stronger growth is precluded by farmers' desire to rebuild equity, the use of funds to buy land for feed rather than buying more cows and sheds, and constraints on credit availability in some regions.
- The domestic US market is only expected to show modest growth over 2014, as recent challenges are compounded by further increases in retail pricing.
- This will enable US processors to substantially increase exports again in 1H 2014 (up 40%). Counter-intuitively, the US will be less well placed to boost exports in 2H, with the increase in milk production more or less offset by the lack of stocks available to drawdown compared to that seen in 2H 2013.

Figure 2: Milk production growth in key export regions, Nov 2013-Jan 2014

YOY change (percent)		
	Jan-14	Nov 13 through Jan-14
EU*	4.6	4.1
US	1	0.3
NZ	6	4.8
Australia	3.1	0.3
Argentina	5.5	5.1
Brazil	13.1	11.6
Total*	4.4	3.7
*Rabobank estimates		
Source: Rabobank, AMI, USDA, DA, CEPEA, Alimentos Argentinos, 2014		

New Zealand

- Buoyed by favourable weather, exceptional milk prices and ongoing investment in herd expansion, New Zealand milk production was up 6% in the season to January 2013. Broadly reflecting this, export volumes for the three months to January 2014 were up 7% (64,000 tonnes) on the prior year.
- For many in the North Island (58% of New Zealand milk production), the run of good weather came to an end in February, with rainfall less than 50% of normal levels through the month. However, the impact on milk production growth will be limited compared to 12 months earlier. Crucially, farmers also hold high levels of supplementary feed due to the very favourable spring conditions and favourable season up until January.
- Producer confidence has been boosted by Fonterra raising their 2013/14 milk price in late February by NZc 35 to NZD 8.65/kilogramme milk solid (MS) (up 57% or NZD 3.15/kilogramme MS on the same period last year). Milk production remains exceptionally profitable.
- As a result, milk flows have held up well as supplementary feed is utilised and more is able to be purchased given the very favourable milk prices. Rabobank expects the final three months of the season (to May 2014) will see production at least 20% to 30% higher than the drought-impacted poor

finish to the 2013 season, when production fell 25% for that three-month period.

- An abrupt end to the North Island production season is unlikely, with a tropical cyclone expected to bring significant rain in mid-March.
- Export volumes taper off through Q2 annually as the production season ends. However, shipments are likely to continue to trend at least 10% above the previous year through Q2 2014 due to higher milk flows.
- Milk production in 2H 2014 (the start of a new New Zealand season) can be expected to provide a modest increase in milk flows from 2H 2013. Incremental growth from new dairy herds, driven by a strong milk price (although not as high as the exceptional current price), will be conducive to further milk production growth that will also flow through into 1H 2015. However, the exceptional spring weather encountered in 2013 is unlikely to be repeated.
- With the expectation that little or no inventories are held by New Zealand exporters, other than to smooth the lack of winter milk production, monthly exports through to 1H 2015 can be expected to track the milk curve and trend modestly above the prior year.

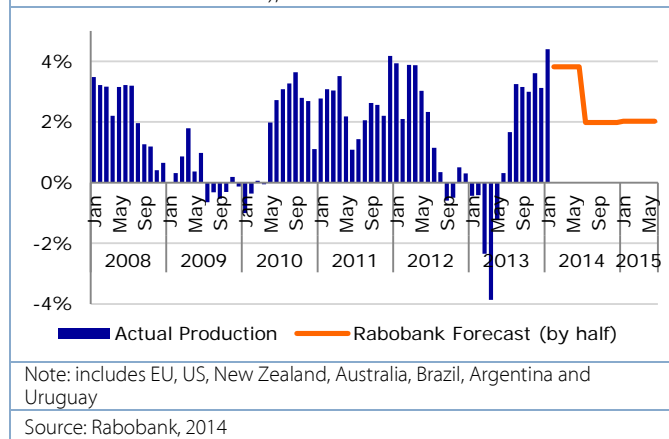
Australia

- Australia's season-to-date production (at the end of January) volumes now stand at 6 billion litres, down 2.2% on the same period last season. This season has proven difficult for farmers given the lingering impacts of last year's drought, stubbornly high purchased feed costs and more unfavourable weather.
- Many key dairying regions again had a very hot dry summer. And while milk prices have been strong in the South, feed prices have stayed high due to strong export demand for Australian wheat and dry conditions in the North.
- However, milk flows did rise above prior year levels in December (+1.5%) and January (+3.1%) on the back of increased farmgate prices for southern producers and improved seasonal conditions.
- Northern dairy producers, who service the domestic market, have not benefitted from the booming commodity market and are also facing a significant dry spell. Season-to-date milk flows are in negative territory for all of these regions.
- Southern producers are now enjoying the benefit of a very firm commodity market as well as the added benefit of a weaker Australian dollar. Murray Goulburn recently announced a fourth step-up for the season, taking the milk price to AUD 6.53/kilogramme MS. The company is signalling further step-ups with an anticipated full-year closing price of AUD 6.70/kilogramme MS.
- Dairy export flows over the three months to December 2013 were down 10% on the same period last season, reflecting reduced milk flows. Australian dairy exporters have continued to adjust production schedules where possible to maximise export returns. In the three months to December, exports of WMP jumped 12%, while SMP shipments fell 25%.
- Rabobank expects a further recovery in milk flows in 1H 2014, on the back of better weather and high milk prices. Production

is likely to come in around 2% up on the same period of 2013. This should generate a small increase in exportable surplus.

- Moving into 2H 2014, Australia's exportable surplus should increase on the previous year. The sector is expected to carry momentum and confidence into the new season on the back of sustained high farmgate milk prices, lower feed costs and a likely return to more normal seasonal conditions.

Figure 3: Milk production growth Big 7 exporters (actual and Rabobank forecast), 2008-2015



Brazil

- After peaking at BRL 1.12/litre in October, farmgate milk prices fell modestly over subsequent months to sit at BRL 0.99/litre in February 2014, still up 11% YOY.
- Prices continued to offer handsome margins over feed costs, driving double-digit growth in supply in the three months to January on weak prior year comparables.
- With domestic demand growing only marginally amidst slow economic growth and rising retail prices, rising production enabled Brazil to almost halve imports in late 2013 and early 2014.
- Production conditions deteriorated somewhat from January. The South East of the country (accounting for 40% of national production) entered a drought during a normally wet period. Pasture quality has suffered and anecdotally is being reflected in the volumes received by processors in February and March. The South of the country (33% of national production) has so far been unaffected.
- Drought is also delaying the planting of Brazil's second corn crop, which has driven up the price of corn.
- In response to concerns over the potential impact of the drought, spot prices for milk increased dramatically in March. It is widely expected that the next couple of months will see considerable gains in farmgate milk prices in Brazil.
- The drought in the Southeast will slow supply growth from the double-digit rates evident at the turn of the year, with national production likely to be up 5% in 1H 2014 on weak prior year comparables.
- Growth will slow further in 2H (2%) as we begin to overlap an exceptionally favourable prior year period.
- With local demand growth expected to remain weak, this brings the prospect of six months of reduced import activity from Brazil, as supply expands faster than local demand.

Argentina

- In Q4 2013, Argentina's milk production grew 5% YOY, with 6% growth evident in the January to February 2014 period. Production has been buoyed by favourable weather and an attractive milk/corn price ratio.
- Confusingly, despite rising production, exports are reported to have fallen 17% in Q4 in YOY terms, and by 23% in January. Early indications suggest a pick-up in February shipments, which would be easier to understand.
- Although production in the January to February period is 6% up YOY, we expect 2014 to see only modest growth in production of between 1% and 2%.
- The primary reason for such modest expectations is the escalation of economic problems and the uncertainty of how far they will run.
- Economic woes have seen the peso depreciate 60% between January 2013 and January 2014, with further depreciation widely expected.
- Not only does such depreciation drive up the peso cost of feed grains, but as a hedge against currency depreciation, farmers have held onto feed crops (especially soybeans) rather than sell, tightening feed markets and driving up the cost of milk production even further.
- Producers will also face sharp increases in land rents when leases are renewed (typically in April/May). More generally, producers face cost increases on many fronts with inflation likely to exceed last year's 30% in 2014.
- While the milk price in Argentina is high by historic standards, it is lower than in most regions of the world in comparable currency terms. The government is attempting to control inflation by fixing food prices, including dairy products, and this limits companies' abilities to pay higher prices to farmers (particularly for the biggest companies that cater mainly to the domestic market).
- With milk prices rising slower than costs, margins have been eroded in recent months, and this will likely continue in coming months.
- Given the recent depreciation of Argentina's currency and the strong recent production growth, we would normally expect exports to rise well above prior year levels in the coming months. However, in late February, the government announced it would approve no new export permits during March.
- The most plausible explanation for the limiting of export licences is an attempt to limit the transmission of high international prices into higher local milk prices, which in turn would feed into retail markets.
- The restriction is supposed to be temporary, but there are no guarantees and this only adds to the prevailing uncertainty.

Demand side

The demand side of the global dairy market remained generally weak in recent months, with falling milk supply in key emerging markets and the need to refill pipelines still providing most of the buy side interest.

In the EU (20% of global consumption), a slow recovery in the economy and the lapping of weak prior year comparables have brought evidence of the first signs of improvement in dairy consumption in this region. In Q4 2013, sales volumes of key product lines appear to have stabilised or returned to fractional growth in the German and French markets, while the Spanish market is seeing 2% plus growth on the depressed levels seen in the prior year. EU wide disappearance numbers suggest that the region as a whole is consuming somewhat more product than 12 months prior. The recovery might have been stronger were it not for the re-emergence of retail dairy price inflation in late 2013 and the lack of employment growth so far generated by marginal economic growth.

After an encouraging six months, growth in the US market (15% of global consumption) appears to have slowed through the closing months of 2013. The reduction of assistance to poorer Americans (via the reduction in SNAP payments and the end of unemployment extensions) appears to have partly offset the benefit of further employment growth. Fluid milk sales contracted heavily in October and November (down 3.5% YOY), while domestic cheese disappearance grew by just 1.7% in Q4 (half the pace of the prior six months). Somewhat disconcertingly, the slowdown in the US market came before consumers felt the full impact of the recent commodity price boom in retail prices (class I and III prices were 10% and 23% higher, respectively, in February than they were in November 2013).

In emerging markets, the vast majority of which rely on imports for a significant share of their supply, just getting hold of product to fuel market expansion has remained a huge headache.

The volume of product available for international trade contracted through Q2 and Q3 2013, and with China strongly increasing its purchases during the period, less was available for the rest of the market.

As anticipated, the volume of product available on the international market rose in Q4 2013 (up 11% YOY) as the recovery of milk production in surplus regions made its way through the supply chain. However, another surge in Chinese buying saw more than the entire increase in supply soaked up by China alone, with the rest of the market again left with less to go around. Available data for January and February suggest an acceleration of Chinese buying occurred over this period (trade was up an estimated 60% YOY).

We remain convinced that frenetic Chinese buying has more to do with falling local milk production than a surge in end use consumption in this country. Evidence includes not just official reports of a 6% contraction in milk supply in 2013 but also sharp increases in farmgate milk prices in 2013, instances of empty shelves of UHT in some regions and rampant inflation at the retail level.

Venezuela has borne much of the brunt of reduced supply availability and exceptionally high world prices wrought by the surge in Chinese imports. Faced with an unravelling economy, a lack of government funds to support traditional food programmes

and currency depreciation (making US dollar prices look ever more expensive) the country has been quickly priced out of the market, with imports down 14 percent in 2013.

For those not suffering a local economic meltdown, the challenges of almost 12 months of restricted supply availability are starting to become apparent. Algeria slashed purchases from the world market in 2013 in the face of exceptionally high pricing. But mounting evidence of local product shortages and the civil dissatisfaction that it is causing have encouraged the resumption of a strong buying programme in 2014, including an unusually large tender closed in early March.

More broadly, the cost of dairy products rose strongly in many emerging markets in late 2013/early 2014, dampening market growth.

Rabobank expects that demand for dairy will continue to exhibit slow but positive growth in Western markets as we progress through the 12-month forecast period. Improving employment levels in the US will more than offset the headwinds of further price rises and lower support for poorer Americans than 12 months prior—with growth forecast in the region of 1.5%. Stable EU employment levels and improved sentiment should continue to push consumption of key product lines marginally above the weak levels evident through 2013, with 0.2% growth factored in.

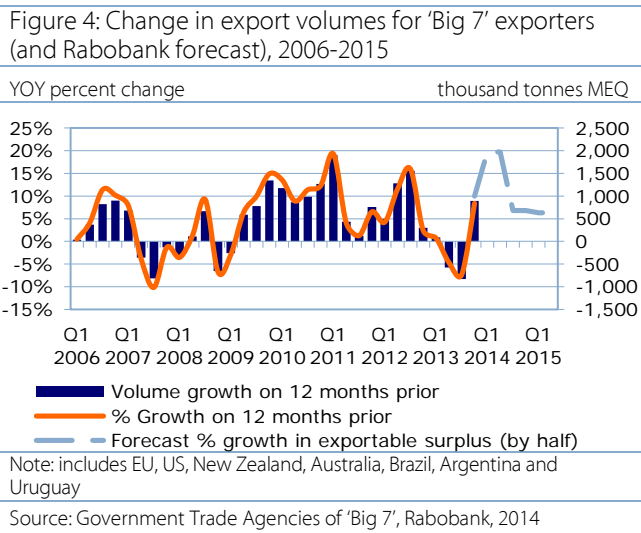
But the most crucial demand side question is whether China will sustain the frenetic buying we have seen on the international market throughout the last 12 months.

Those hoping for a sign of a break in the trend will have noted two recent developments. Average raw milk prices in China fell in January (for the first time in 20 months), while WMP prices fell 5.7 percent in the 5 March gDT auction. While the shifts were small, it is conceivable that they represent the first signs of a lessening of the local supply crisis and an easing of Chinese purchases. Alternatively, it could reflect a quiet period for buying after the Chinese New Year.

Rabobank expects that Chinese imports will grow less strongly than they have in the opening two months of the year as we progress through 2014. We expect a small contraction in milk production in 1H to be followed by a small rise in 2H due to better weather, the dissipation of disease impacts, stronger farmer returns and the ongoing commissioning of larger dairy farms. Factoring in a 2% to 4% growth in demand this year, that will leave China needing a 15% increase in imports over the balance of the year (having topped up hugely in January and February).

Not every importer stands ready to expand purchases in the coming months. Venezuela is suffering from a toxic mix of problems that is unlikely to be resolved in 2014. Russia remains short on milk, but the economy was already slowing before the Ukrainian crisis: which has seen the rouble fall (increasing the cost of imported product) and brings a range of negative economic possibilities, depending on how trade partners and investors respond.

Nonetheless, after 12 months of enforced dieting, importers in other regions like South East Asia, the Middle East and North Africa are expected to jump at any chance to procure more from the internationally traded market over the balance of 2014. The question is whether prices need to fall to unlock that demand, and if so, how far (noting that many emerging market currencies have weakened in recent months as the US tapers quantitative easing).



Outlook

Rabobank expectations

- Q2 2014 will continue to bring a period of very strong growth in exportable supply from the world's key surplus regions as producers respond to high milk pricing and low feed costs. The strong recent momentum in the EU will start to be replicated in the US as a harsh winter passes and new forage crops are cut.
- Milk supply in export regions is forecast to rise more than 3.3% YOY during 1H as the tail end of a strong Southern Hemisphere production season overlaps with a strong Northern Hemisphere season.
- While consumption in some export regions will also rise, the rate of growth for surplus regions as a group will be limited by slow employment growth, limiting consumption growth in these regions to around 1% YOY in 1H 2014.
- Rising milk supply should therefore generate a large increase in exportable supply (forecast up 20% YOY in 1H 2014—or by 5 billion litres in LME terms) for the international market.
- Facing consumption growth in the low single digits, and only steady local production, Chinese purchases from the world market are expected to rise in the region of 25% in 1H 2014 (or by 1.1 billion litres in LME terms).
- This will soak up a share of increased international supply, but leave almost 4 billion litres of additional export supply to be shared among other buyers in 1H 2014.
- With economies generally improving in emerging/deficit markets, and stocks at critical lows, this product is expected to be bought up eagerly.
- However, pricing will need to ease somewhat to ensure this occurs, reflecting the less strict rationing of supply required from around mid/late Q2 when the Northern Hemisphere season peaks.
- In 2H 2014, milk production growth will slow in several regions as prior year weather (and hence comparables) proves harder to significantly improve on. The US will also have less stocks to drawdown than it did 12 months prior.

- Global demand is also likely to improve somewhat in 2H 2014, assuming the world economy remains on a slow recovery track.
- Nonetheless, spill-over from strong growth in exportable supply generated in the first half of the year, expectations of a solid Southern Hemisphere season, and some slowdown in the growth in Chinese buying should see prices ease modestly through 2H 2014.
- Developments that would lead to a higher or lower price outlook than presented here are outlined below.

Upside influences

- The market will require a strong Northern Hemisphere supply peak (in April/May) if prices are to ease in the near term. Any significant adverse weather on a widespread basis in the EU or the US would keep the market tight and pricing from falling.
- If Chinese milk production continues to fall in 2014 (rather than stabilise), import growth will exceed our estimates and provide further support to prices.
- If the March halt on issuing export permits by the Argentine government is extended, the world will lose a useful contributor to export supply.

Downside influences

- We assume that Russia will continue to increase purchases from the world market in 2014 to supplement local market shortages. A significant economic slowdown or trade disruptions resulting from the Ukrainian crisis could change this scenario.
- Emerging market buyers (besides China) may not come back to the market with the same force we anticipate, given the recent slowdown in their economies and generally weaker currencies.

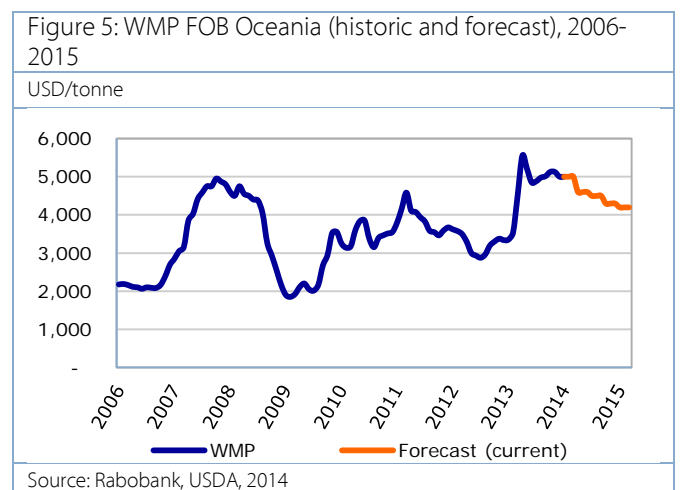


Figure 6: Quarterly dairy commodity prices (historic and forecast)

		Q1 2013	Q2 2013	Q3 2013	Q4 2013	Q1 2014	Q2 2014	Q3 2014	Q4 2014	Q1 2015
World (FOB Oceania)										
Whole milk powder	USD/tonne	3,739	5,202	4,952	5,035	5,000	4,600	4,500	4,300	4,200
Skim milk powder	USD/tonne	3,652	4,835	4,595	4,648	4,850	4,400	4,300	4,150	4,050
Butter	USD/tonne	3,636	4,321	4,041	4,135	4,600	4,500	4,300	4,100	4,000
Cheddar cheese	USD/tonne	4,071	4,529	4,393	4,620	4,970	4,550	4,450	4,300	4,250
Sweet whey powder	USD/tonne	1,315	1,396	1,396	1,380	1,432	1,375	1,300	1,250	1,200
US (AMS announced)										
NFDM	USD/lb	1.55	1.62	1.76	1.87	2.06	1.78	1.73	1.67	1.63
AA butter	USD/lb	1.56	1.63	1.43	1.53	1.74	1.78	1.69	1.60	1.56
Block Cheddar	USD/lb	1.68	1.79	1.73	1.83	2.17	2.02	1.95	1.86	1.82
Whey powder	USD/lb	0.59	0.54	0.54	0.58	0.62	0.62	0.59	0.57	0.54
Class III milk	USD/cwt	17.44	18.04	17.65	18.71	22.39	20.55	19.68	18.66	18.10
Class IV milk	USD/cwt	17.71	18.62	18.99	20.71	22.93	20.67	19.90	19.01	18.43

Source: Rabobank forecasts, USDA, 2014

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