Poles Apart

Method Crucial When Unlocking Poland's Dairy Potential

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The dairy industry in Poland provides plenty of investment opportunities to those players who have the right strategy. At the farm level, production has increased, although further investment is needed to realise Poland's full potential after the removal of quota in 2015. At the processor level, consolidation and improvements in efficiency would provide opportunities to tap into domestic and export markets. Finally, at the consumer level, domestic consumption of dairy products has increased overall but is still well below EU averages, so there is further potential. However, the industry's natural suspicion towards foreign companies may require a change in how outside players should operate. This could mean getting a partner or acquiring existing domestic businesses rather than dropping a foreign model into the market.

Introduction

The abolition of milk quotas in the European Union (EU) from April 2015 will be a watershed moment for the EU dairy industry. From this point, EU milk markets will not be constrained by limits on milk production and we are likely to see a 7 percent to 8 percent increase in supply between 2015 and 2020, equivalent to an additional 10 million tonnes per year by 2020.

In a Rabobank report published in 2012, Poland was highlighted as one of the few players who will expand their market significantly.[1] Favourable conditions for milk production, together with a comparatively underdeveloped domestic market, give Poland an advantage over other EU countries as it does not have to focus entirely on export markets.

While there are undoubtedly opportunities and gains to be made, Poland provides challenges too. It may be that outside investments need to be linked more closely with domestic players to unlock the rewards that Poland could provide.

Milk production—Untapped potential

Since joining the EU in 2004, Poland has seen a marked increase in milk production and is now the fourth largest milk producer in the EU.[2] However, there is still further potential for increased milk production, particularly after quotas cease in 2015.

Country-specific conditions are attractive

Poland is well suited to milk production due to its low land prices, good infrastructure, and particularly the potential for grassland development. Poland is a relatively low-lying country with grassland accounting for roughly 20 percent of available agricultural land. Grass production is currently between 5 tonnes and 7 tonnes of dry matter per hectare per year and is predominantly concentrated in the northeast of the country. In comparison, the UK and Ireland, which are more developed in terms of grassland management, achieve somewhere in the region of 10 tonnes/hectare. This already demonstrates the potential for future expansion of milk production in Poland from grass. Furthermore, pressure from urban land development is lower in Poland than in other parts of Europe. As a result, average agricultural land prices in Poland were among the lowest in the EU at approximately EUR 4,900/hectare in 2011. In comparison, land in Germany was approximately EUR 13,500/hectare. Rental prices for land in Poland, at EUR 174/hectare in 2011, are also low compared to elsewhere in Europe. There is relatively little regional variation in rental prices, but the more expensive areas are situated in the centre of the country.

[1] See Rabobank report *EU Dairy Expansion Post-2015: How Will the EU Dairy Sector Transition to a Quota Free World?* (November 2012).
[2] Includes unofficial production estimates.

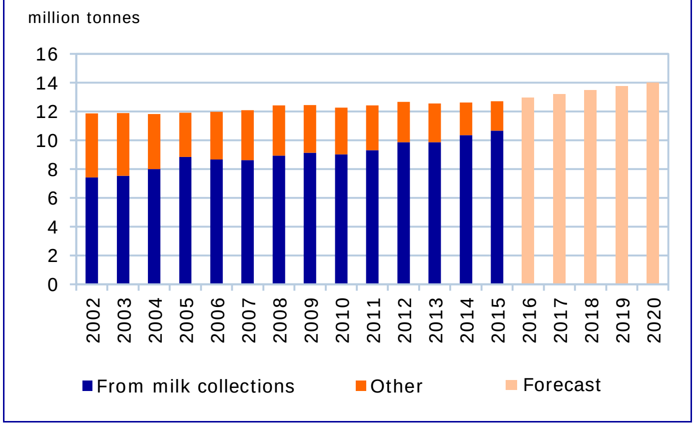
Poland is also geographically well-suited to milk production. In addition to its central location and good road/rail connections, the country also has access to a deep water port at Gdansk. However, while infrastructure in the north is relatively well funded, further investment will be required to bring transport connections in the south up to the same standard.

Milk production continues to increase

According to official figures, 9.8 million tonnes of milk was collected in Poland during 2012, making it the sixth largest producer in the EU. However, the informal dairy sector is still considerable in Poland, and we estimate actual milk production to be more than 12 million tonnes, which would make it the fourth largest EU producer. The informal sector has been shrinking as the industry develops and will likely to continue to do so (*see Figure 1*). As a result, the gap between milk quota and declared production of raw milk in the formal market has reduced. In 2010, production was 7 percent below milk quota, whereas by 2012, production was only 1.5 percent below total milk quota (*see Figure 2*). In the 2012/13 production year, wholesale quota (part of the total milk quota) was exceeded by 0.14 percent.

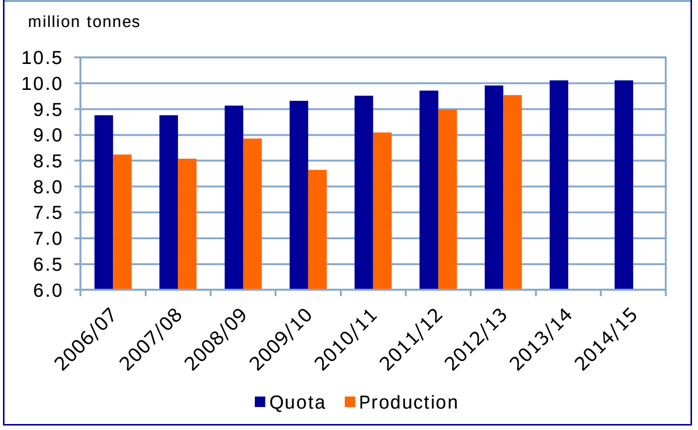
While there is much debate over what will happen to milk production following the end of milk quotas, we anticipate a 10 percent increase in milk production between 2015 and 2020. There are two reasons for this. Firstly, milk produced in the informal sector—outside of quota legislation—will be absorbed into the formal sector as informal herds disappear. At the same time, businesses in the formal sector are expected to expand quickly as they are no longer impeded by quota.

Figure 1: Polish raw milk production, 2002-2020



Source: BGZ Bank, Rabobank analysis, 2013

Figure 2: Milk quotas versus formal production in Poland, 2006/07-2014/15

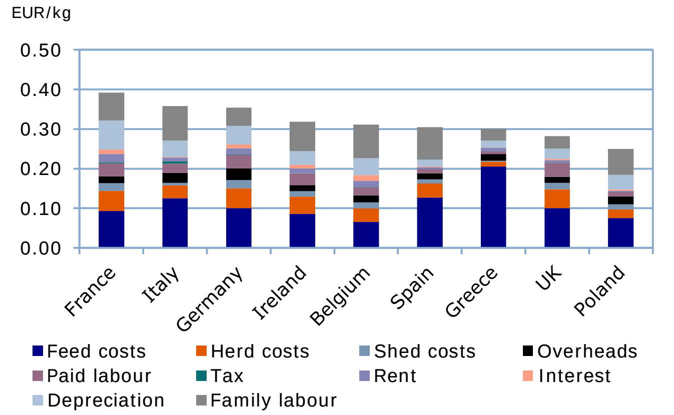


Source: BGZ Bank, Rabobank, 2013

Production costs are favourable

One advantage that Poland currently has is a comparatively low cost of milk production compared with other EU member states. Feed and labour (family and unpaid) are the main cost advantages (*see Figure 3*). However, analysis shows that while still comparatively low, feed costs increased by 12 percent between 2009 and 2011, accounting for 30 percent of total costs.

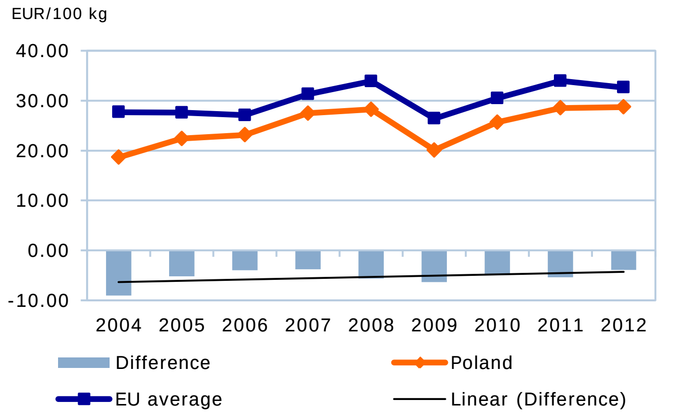
Figure 3: Cost of milk production comparison, 2011



Source: FADN, 2012

These lower production cost elements may partly explain why Poland has a comparatively lower milk price than elsewhere in the EU. From a milk quality perspective, butterfat and protein are comparable with other EU countries. Poland's milk price was almost 12 percent less than the EU average in 2012, a price difference that is only showing gradual signs of reducing (*see Figure 4*).

Figure 4: Comparison of raw milk (3.7% fat) prices, 2004-2012



Source: EU Commission, Rabobank, 2013

Markets—A mixed bag

Since accession to the EU in 2004, Poland has invested heavily in its dairy industry. While the farming and processing sectors have potential to grow as exports perform well, the domestic market has remained stagnant in recent years.

Domestic demand can build

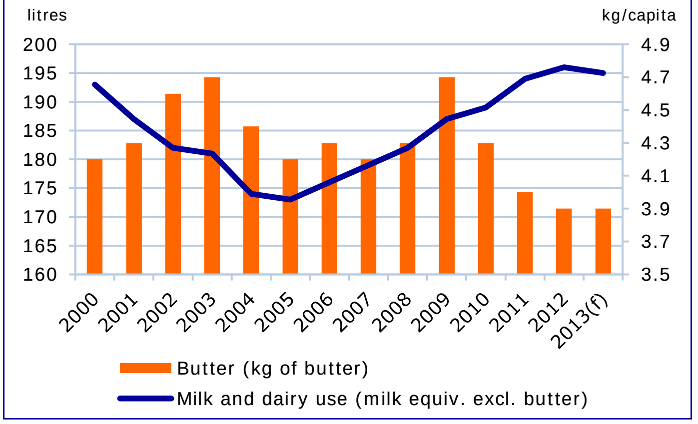
While the Polish population has remained stable at approximately 38.5 million, GDP has been steadily increasing in recent years. Per capita GDP has increased by 43.3 percent since 2004 to USD 6,854 per capita in 2011. Consumer spending has also been increasing and exceeded more than USD 220 billion in 2011, an increase of 9 percent on 2010. In contrast, per capita dairy product usage has only increased 1.5 percent per year (*see Figure 5*). Compared to other western European countries, it appears that the Polish consumer market is still maturing.

Similar to other countries, Poland has seen the per capita consumption of liquid milk decline by more than 30 percent over the last ten years. In contrast, the consumption of products such as hard cheeses and yoghurts increased by 26 percent and 70 percent, respectively, over the same period. However, while consumption has increased, it is still much lower than EU averages, suggesting further potential to expand.

Box 1: Consumption profile in Poland still developing

Overall, Poland consumes 42 kilogrammes of liquid milk per capita, 11 kilogrammes of cheese per capita and 4 kilogrammes of butter per capita. It is important to note that Polish retail markets are dominated by local brands and international labels are less prominent. Polish-owned brands account for 13 of the top 20 dairy brands. In fact, brands of international companies (either their own or via Polish subsidiaries) only account for 25 of the top 100 listed in 2012. Development of new products, such as dairy desserts, has been slow as there is no history of consuming such products.

Figure 5: Annual per capita butter and dairy use in Poland, 2000-2013f



Source: Central Statistical Office of Poland, 2013

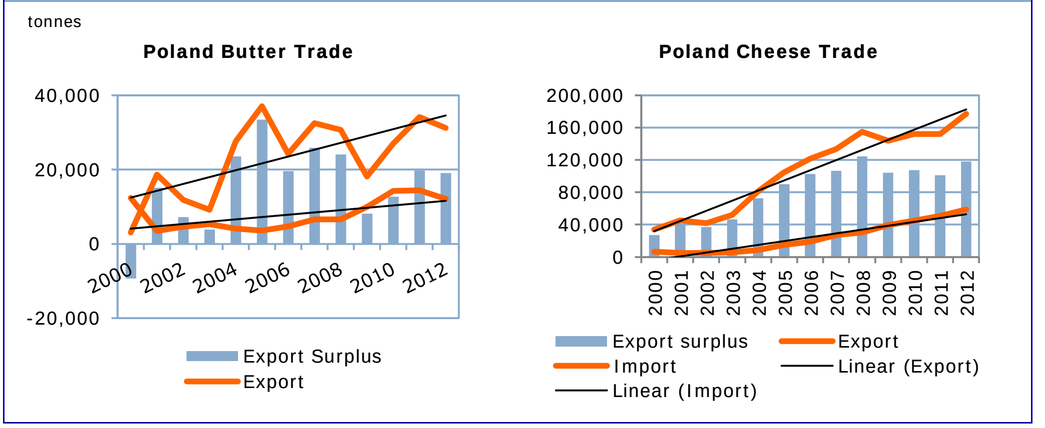
Retailers have bargaining power

Unlike the products sold, the composition of food retailers in Poland is a little more cosmopolitan. Of the top ten retailers, only three are Polish companies. However, the market is still fairly fragmented with almost a quarter still made up of small, independent companies. The amount of consolidation still left to occur within the sector brings increasing bargaining power, which will provide a challenge to milk processors. Increased competition is certainly likely as the best growth performance within the Polish retail sector is in discount stores, where price competition is typically fierce.

Polish dairy exports are already developing

The dairy market in Poland was valued at USD 4.1 billion in 2011, accounting for 17 percent of total agricultural production. While there is still room for further development, Poland has developed a healthy trade balance in several dairy commodities (*see Figure 6*).

Figure 6: Polish butter and cheese trade, 2000-2012



Source: Eurostat, 2012

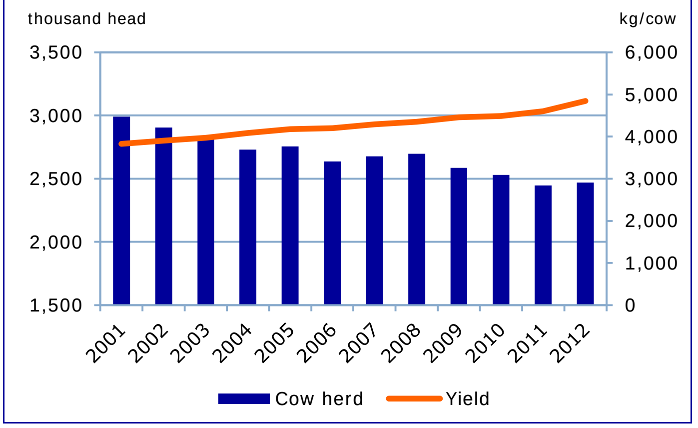
Butter trade has seen ups and downs over the last decade, although exports have been on an upward trend. The main destinations of butter exports include Germany, the Netherlands, the Czech Republic and Slovakia. Trade in cheese has been more consistent with exports at almost 180,000 tonnes in 2012. Top destinations are the Czech Republic, Italy and Germany. Although exports of butter to Germany have been on a downward trend recently, exports of liquid milk to Germany have been increasing, suggesting the use of Poland as a source of raw materials. While this has been occurring, exports of cheese to Russia in particular have shown significant growth in recent years, with 2012 data suggesting a 79 percent increase YOY. While most exports centre on Europe, other destinations showing promise include Saudi Arabia and Iraq.

In the future, less is likely to be more

Although the Polish dairy industry has progressed rapidly in recent years, there are several challenges to future progression that span across the supply chain, which remains fragmented and inefficient. A programme of consolidation, beyond what is already occurring, is needed to help improve the industry. We believe that at the producer and processor level, the pace of this process will increase after the quota is abolished in 2015.

Yields per cow are low at 4,850 kilogrammes per year, compared with the EU average of 6,800 kilogrammes per year (*see Figure 7*). However, this figure includes production from the informal sector, where a herd may consist of only one or two animals. As consolidation accelerates, production will concentrate on larger, more efficient farms, and average yields per cow are likely to increase significantly.

Figure 7: Cow herd and yield in Poland, 2001-2012



Source: AMI, BGZ, Rabobank, 2013

Consolidation is already underway. Estimates suggest that there were only a total of 410,000 farms in 2011, down from 550,000 in 2008. Of the total in 2011, 168,000 were registered with milk quota although the exact number of farmers in the industry is unclear as many exist outside of government systems.

However, while continued consolidation at the farm level will be required to move the industry forward, there are barriers. Unlike many other countries in the former Eastern Bloc, Poland had a high degree of private ownership under communism, particularly in dairy farmland in the east. State farms were located close to the German border, concentrating on arable production and growing over time. Therefore, when communist rule ended, farm ownership and size changed little in dairy-heavy areas. Land in Poland is perceived by many as an insurance policy, a place to return to in case of unemployment, which has affected the agriculture sector. Owners are unwilling to sell in case they need it later.

As there is movement towards consolidation in the retail sector, the likely increase in retail bargaining power may mean a reduction in the number of milk processors. The top ten milk processors in Poland account for only 50 percent of the total market. Two companies, SM Mlekpol and SM Mlekowita, have an intake of more than 1 billion litres. In addition to the consolidation of companies, the processing sector would also benefit from programmes to improve efficiency. For example, labour efficiency in processing plants is roughly 250 tonnes per employee. In Germany, this is closer to 750 tonnes per employee, so improvements can clearly be made.

Box 2: Challenges in the south

The south of Poland is a challenging proposition for the dairy market, although it could provide bigger rewards for those who succeed. It has a larger informal sector, with most of the milk produced for on-farm consumption. As a result, herd sizes are much smaller than elsewhere in the country. Another factor to consider is the lower level of investment in infrastructure compared with the north. This is possibly due to a combination of lower employment and the resulting labour migration to the north. However, while these are indeed challenging factors, there could be an opportunity to work with the government and other agencies to develop this part of the country.

Don't play the foreigner card

Although Poland is an attractive country for dairy production, primarily due to the low cost of raw milk, opportunities for new players have been limited and the experiences of major international dairy players in Poland have been mixed.

One of the main problems has been obtaining raw milk. It is very difficult for new entrants to establish a secure supply from local farmers, who have long-term agreements with local dairy co-operatives in the form of promissory notes. Farmers agree to meet certain criteria regarding quality and volume. In return, the processor guarantees to pick up the milk at a price fixed for a long term. Furthermore, local famers have had trust issues with international players. International players have offered contracts as they would in other countries, but because the price has varied seasonally and with market conditions, local farmers have preferred to stay with domestic milk buyers who offer a more stable price.

Polish brands are strongly positioned in retail sectors and polish consumers do not switch easily. Similar to farmers, consumers are suspicious of anything without a recognisable Polish name. In addition, it is hard to compete with the low prices that Polish brands can set. Consumers are price-sensitive and although GDP per capita is rising, the amount spent on groceries remains the same. International players may struggle with the high investment levels of entry while delivering cheap prices at the retail level. Moreover, due to the many active players, competition is fierce and will focus mainly on price. Non-price competition is possible in subsectors like yoghurts, cheese and dairy-based desserts.

Method is key to unlocking opportunities

Although there are clearly challenges to overcome, there are a large number of investment opportunities across the Polish dairy supply chain. Whatever the strategy, it is likely to be more effective in a local wrapper.

Investment in farming

There is plenty of potential to grow supply. Farms need to consolidate, increasing milk yield and/or herd sizes. Therefore, investment in additional stock as well as housing and machinery is key. There is also a need to improve technical efficiency in order for Polish farmers to continue to benefit from lower production costs. Therefore, companies involved in farm machinery or in providing technical knowledge could find opportunities by partnering up with domestic players.

Investment in processing/trade

Poland already has a growing trade in commodity products and has built up to become a net exporter. However, improvements could still be made in the productive efficiency of processing plants. Again, investment opportunities are available in sharing facilities or bringing in new technology. With growing pressure from retailers, domestic processors may need to consolidate, providing a window for mergers and acquisitions (M&A) or joint ventures (JV) with well-known, domestic companies.

Thinking laterally

There is also the possibility of looking at Poland as a milk supply base rather than a market to develop. Given its central location, milk could be taken out of the country and processed elsewhere in Europe, using local milk brokers to acquire the milk.

One example of this would be the recent reduction of cheese exports to Germany, with exports of liquid milk to the same destination increasing. It is possible that German companies are already looking to Poland as a raw material source, importing milk to turn into cheese rather than importing the finished product.

Conclusion

Poland clearly has the potential to become one of the major dairy players in Europe. Milk production has the capacity to expand further through restructuring at the farmer level towards larger herds and improvements in feed management. Domestic markets are still immature, with certain product streams yet to be tapped. Coupled with an already established export industry, this puts Poland in a good position to move forward, even if historic constraints and suspicion of foreign players has hampered this transition. Rabobank believes that outside players should look to adapt their methods and to partner with domestic companies in the Polish dairy supply chain.