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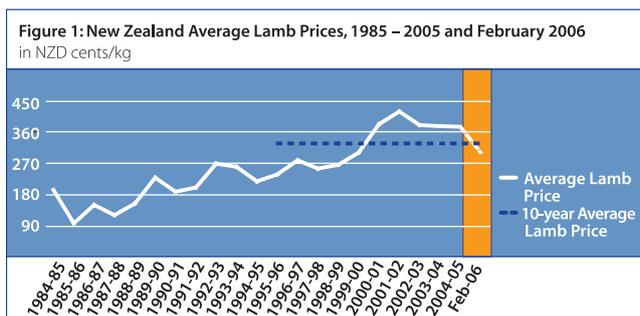
Sheep Meat – the resurgence of a key industry

Autumn 2006

New Zealand's sheep industry has returned to prominence in recent years on the back of strong export returns and the realisation of benefits from productivity improvements.

However, despite a dominant global market position and an enviable reputation, the sheep meat industry cannot rest on its laurels. The challenges of a high New Zealand dollar, increasing costs of production and the easing of international prices from record high levels, have combined to create uncertainty over industry returns in early 2006.

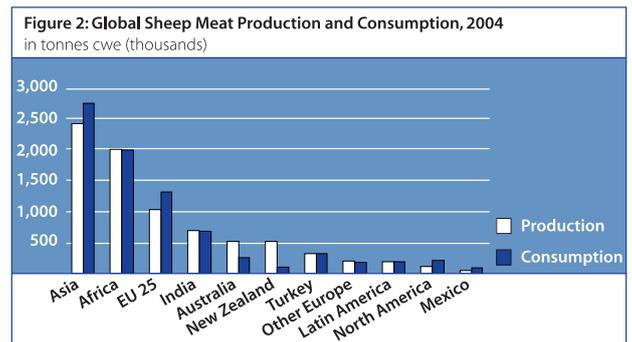
New Zealand lamb's natural quality attributes combined with an unmatched disease free status and the ability of the industry to service market requirements has seen lamb stand tall amid the turmoil of international meat trading in recent years. By avoiding the devastating impacts of disease outbreak New Zealand has managed to retain very high levels of consumer confidence in its sheep meat export markets and this has stood exporters in good stead through a particularly turbulent period for the world's animal protein exporters. With limited supply internationally and disease impacting markets for beef and poultry, market tension has favoured producers and exporters. New Zealand farm gate prices moved to a higher level that has been sustained for several years. However, with increased lamb supply and global demand showing some softening trends there have been significant farm gate price reductions in 2006. Figure 1 illustrates the impact of uncertainty in the market during late 2005 and early 2006.



Source: Meat and Wool New Zealand Economic Survey, Agri-Fax, Rabobank, 2006

World sheep meat markets are largely self-sufficient

Globally, the sheep meat industry remains relatively small and consumption of the product remains strongest in the country or region of production. The populous and large consumption regions of Asia (primarily China), Africa, India and Europe dominate production (Figure 2). Asia is a key destination for exports alongside the European Union (EU) and North America, as the greatest deficit in local production occurs in these regions.



Source: OECD, Rabobank, 2005

Global consumption of sheep meat is forecast to grow at 1.5-2.0% per annum over the next ten years (OECD-FAO Outlook 2005-2014). This growth is expected to be driven by developing regions increasing their per capita consumption levels from 1.6 kg to 1.8 kg, as income levels rise, combined with population growth of approximately 10% over the period. In contrast, consumption is expected to remain flat in volume terms in the developed world. The exception is the North American market where volume growth in Canada is forecast at 7-10% (from a low base). Value of sheep meat consumption is also expected to grow in both the United States (US) and Canada, due to strong demand, increased immigration and the higher value of cuts consumed.

Per capita consumption of sheep meat varies widely and has declined in developed countries over the past 30 years. New Zealand and Australia are the largest consumers by a long distance. However, the trend in both countries has been declining per capita consumption, as lower cost, high convenience options, like chicken, have taken stomach share. While New Zealanders consumed approximately 30 kg of sheep meat per capita in the 1980s, this has now fallen to below 20

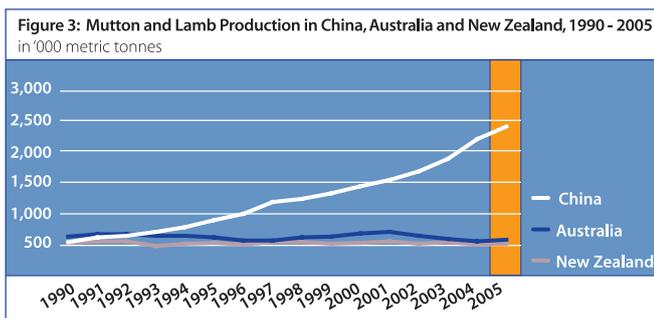
kg. Australians still consume 12 kg of mutton and lamb each year, but this has declined from 20 kg during the 1970s. By comparison the EU-15 consumes 2.5-3 kg per capita with the United Kingdom (UK) the leading consumer at around 6 kg per capita per year.

The long term historical decline in sheep meat consumption can be attributed to changing consumer preferences, both in terms of food and fibre (mainly away from mutton and wool). The rising growth and popularity of poultry during this period has provided an inexpensive, versatile and convenient source of protein as a substitute to lamb. However, in recent times there has been a marked resurgence in the popularity of sheep meat in some key high value markets, driven by increasing acceptance of the quality and convenience of lamb, in comparison to other alternatives. Furthermore, lamb is fast becoming the only truly free range meat alternative, which coincides nicely with changing consumer preferences for natural foods.

China dominates the world flock, but Oceania dominates trade

While global production statistics for animal industries can be imprecise, they provide a useful guide to the changing structure of the global sheep industry. From over one billion sheep worldwide the largest flocks are found in China (171 million) and Australia (103 million), with India, Iran and Sudan also holding substantial flocks each of approximately 50-60 million head. Accordingly, these countries dominate lamb and mutton production. China is the largest sheep meat producer at 2.4 million metric tonnes, followed by Australia (580,000 tonnes) and New Zealand (520,000 tonnes). New Zealand and the UK feature in the top five sheep meat producers due to their productivity and focus on meat production, rather than wool.

Of the 8.5 million tonnes of sheep meat produced world wide, only 10% is traded, with New Zealand exporting over 50% and Australia over 35% of traded volumes (excluding intra-EU trade). While New Zealand and Australia are well-established sheep meat producers and the dominant exporters, the increase in production from China has been significant since the mid 1990s (Figure 3). These volumes have fulfilled growing domestic needs in China. However, China remained a net importer of 35,000 tonnes of sheep meat in 2004, despite this increased production. Per capita meat consumption in China has more than trebled since 1985 and ovine meat has been no exception, lifting from below 1 kg to over 3 kg during this period.

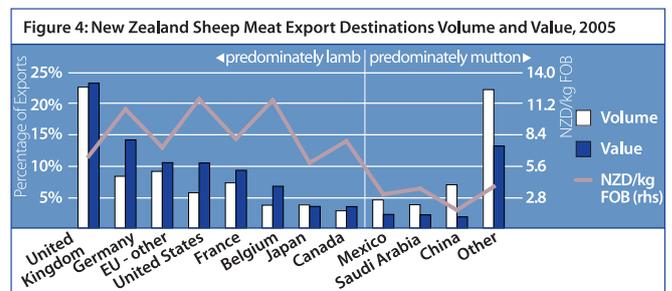


Source: FAO Stat, Rabobank, 2006

With production growth expected to lift domestically in developing countries to meet most of the increased demand, the trade in sheep meat will remain dominated by the existing players. Australia and New Zealand are likely to extend their focus on the higher value markets of Europe and North America. However, developing countries remain an important part of the market for cheaper cuts and mutton as exporters seek efficiencies and profit margin by maximising value across the whole carcass.

Key difference is market value

While the globally traded market for sheep meat is relatively small, it contains two significantly different product streams for exporters. High quality lean lamb meat, often as boneless, chilled cuts is destined for the wealthy consumer markets of the EU, North America and Japan. Meanwhile, lower value mutton or bone-in carcass cuts fulfil requirements in developing markets such as China, Mexico, Saudi Arabia and the Pacific nations. Figure 4 illustrates this difference in volume versus value and the variance in average export price per kilogram for key export destinations.



Source: Statistics New Zealand, Rabobank, 2006

This contrast is exemplified by the value of sheep meat exports to Japan and China. China imported 26,000 tonnes from New Zealand in 2005, almost double the 14,000 tonnes imported by Japan. However, Japan's export value of NZD82 million was nearly twice the NZD42 million of exports to China. This wide difference in value can be attributed to the higher value of fresh, chilled and boneless cuts exported to Japan versus the predominately frozen bone-in product destined for the Chinese market. The contrast is stark in markets like the US, which only accounts for 6% of export volume, but 10% of value.

New Zealand's most valuable export market remains the EU; in particular the UK – the destination for more than 20% of New Zealand's sheep meat exports. The 227,854 tonne (carcass weight equivalent) annual EU quota access New Zealand enjoys provides a significant competitive advantage over Australia, which only holds 18,650 tonnes of quota. As out of quota exports incur a tariff of 12.8% plus EUR 90.20 – EUR 311.80 per 100 kg/net (depending on the product) there is a significant barrier for exporters sending product to the EU market without quota.

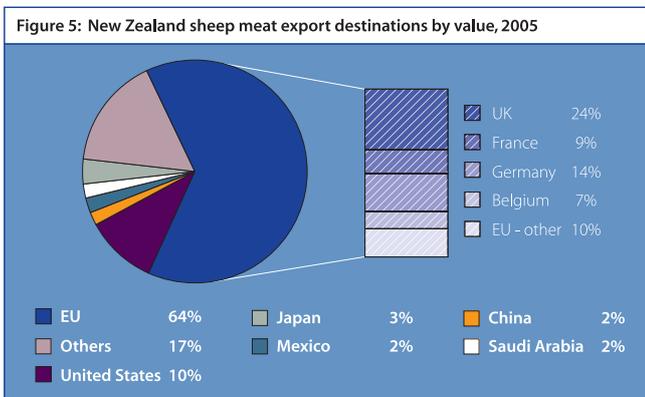
New Zealand sheep meat export volumes to the US declined in 2005 by 23% in a market that increased its import volumes by 1.2% from 2004. By contrast, Australian exports to the US reached record levels and increased 15% by volume. This was largely due to limited New Zealand production being directed toward European markets, while Australian export lamb production increased. The value of sheep meat imported into the US increased almost 16% in 2005 (in

US dollar terms) from the previous year, indicating strong growth in product value destined for this market. On the back of reduced availability of beef and rising beef prices due to BSE-related import restrictions in Japan, New Zealand's lamb exports to Japan lifted 5% in value during 2005. In the absence of reasonable supplies of beef, lamb has appealed to the barbeque and restaurant sector. With rising beef prices and no tariff applicable on sheep meat, lamb is a price competitive source of high quality animal protein in Japan.

The buoyancy of sheep meat demand has not been limited to high value, premium markets. This has largely been driven by the availability of cheaper cuts as prices have increased for prime cuts and alternative animal proteins. In 2005, Mexico imported 20% more New Zealand sheep meat than the previous year. Destinations closer to home have also increased their import volumes with Fiji, Papua New Guinea and Tonga higher by 8%, 11% and 25% respectively in 2005.

The European influence is strong

New Zealand's historical links with the UK continue to be reflected in the dominance of Europe as a key destination for sheep meat. This is particularly true when measured by value, rather than volume, due to the concentration of higher value lamb exports to Europe (Figure 5). While just over 50% of New Zealand's sheep meat exports are destined for the EU by volume, this market accounts for 64% of the NZD 2.4 billion export value. The UK remains the largest single market within the EU holding a 24% value share. Germany, France and Belgium are also important, high value, EU markets.



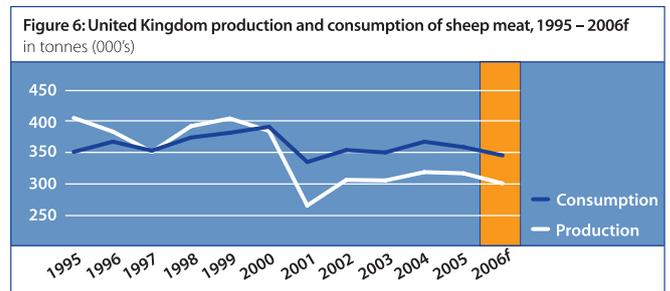
Source: Statistics New Zealand, Rabobank, 2006

The UK retail lamb market is valued at GBP550 million and grew 6.9% in the year to March 2005 (2.7% volume growth). Lamb has also been the fastest growing meat cut in both volume and value terms during this period. However, consumption and price growth slowed during the remainder of 2005 with market value and volume remaining broadly static year-on-year to November 2005 as prices had reached high levels and domestic production increased.

Lamb consumption in the UK is typically part of a traditional meal consumed in the home. This is evidenced by the strong demand seasonality around the Christmas and Easter markets, alongside being traditional Sunday roast fare. Within the foodservice sector, lamb is most commonly available via a pub, Indian restaurant or kebab shop. As most consumers associate lamb with roast meals, the leg and some shoulder cuts are in demand. However, with lamb leg cuts increasing

in value by 39% year-on-year to March 2005 (TNS Superpanel data) sales volumes shifted towards lamb mince, shoulders and steaks during 2005. Consequently, the sale volume of lamb leg cuts declined. This movement evidences the fact that lamb prices had reached the point where consumers sought alternatives – either a different lamb cut or moving to another type of meat altogether.

The 2001 outbreak of Foot and Mouth Disease (FMD) in the UK and the Common Agricultural Policy (CAP) reform occurring throughout the EU has impacted the market for lamb. The FMD outbreak resulted in a sharp decline in both lamb production and consumption in the UK, however, consumption has recovered more quickly (Figure 6). The gap between production and consumption that opened after 2001 has provided growing opportunities for exporters of sheep meat to the UK and with a lower level of supply, prices have strengthened.



Source: Meat and Livestock Commission, EuroStat, Rabobank, 2005.

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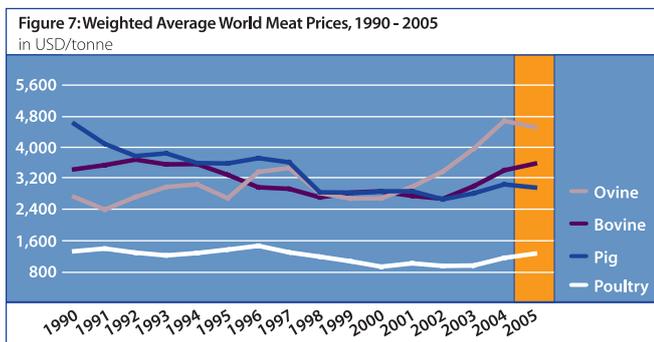
The supply of sheep meat within the EU is being reduced as a result of CAP reform. This has seen the decoupling of payments based on livestock numbers, such as the Ewe Premium in Ireland and the UK, and the use of the Single Payment Scheme from 1 January 2005. The Ewe Premium had previously represented approximately 30% of a UK sheep farmer's gross margin on average. CAP reform has removed the focus on production based incentives for farmers within the EU and payments are now area and land based. The area and type of property (hill, upland versus lowland or crop land) and protection of the environment and the agricultural landscape now provide the basis for payments. Farmers also receive different payment levels depending on their location, i.e. less favoured area, disadvantaged area or severely disadvantaged area.

Farmers are not encouraged to increase production, outside normal market forces, and therefore there has been little incentive to rebuild the sheep flock post-FMD. As the CAP reform has started to impact producer decisions, the cull ewe slaughter within the UK has increased almost 16% in 2005 causing a rise in sheep meat production for the year. The largest increase occurred in Wales and Northern Ireland, with primarily hill properties reducing their breeding flocks. The Irish sheep meat market is experiencing similar trends as the UK, with higher slaughter volumes in 2004 and into 2005 and a decline in sheep numbers over the past 10 years.

The dynamics of UK sheep meat supply have impacted the EU trade balance. The UK exports approximately 25-30% of its annual lamb production, primarily into Continental Europe. With increased production in 2005 export volumes have increased and imports have reduced by an estimated 7%. However, with a reduced flock, lamb

supply will fall and supply levels will eventually drop. Following CAP reform, the EU is expected to become less self sufficient in sheep meat production and will therefore have an increasing reliance on imports over time.

The premium level of lamb prices in Great Britain, relative to other meat species, is indicative of the trend for world lamb prices (Figure 7). With prices at such high levels, approximately GBP1/ kg higher than beef, there are two likely outcomes. Either supply increases in response to the prevailing price or prices reach the point where consumers switch to substitutes, such as beef or pork, until prices fall to an attractive level. These shifts have already occurred to some extent and the UK market price has moved downwards. The extent of substitution will be dependent on the premium consumers are prepared to pay for lamb over other proteins.



Despite the rise in prices for both domestic and imported sheep meat across Europe over the past four years, producers remain under competitive pressure. The production cost advantages enjoyed by sheep farmers in quota holding countries such as New Zealand, Argentina, Australia, Uruguay and Chile cannot be matched by domestic producers. Additionally, the changes in CAP have resulted in European farmers reassessing their businesses within the new environment and sheep numbers are declining in key production areas as a result. Sheep meat quota access may be reviewed within the World Trade Organisation Doha negotiations and as Australia aggressively pursues increased market access for lamb into the EU. However, implementing changes is typically slow.

With expected falls in EU production and limited quota, the availability of sheep meat in the EU is likely to remain relatively tight over the medium term. Additionally, consumers have signalled that the premium that lamb can command over other meat species does have a limit. The EU market price can therefore be expected to remain good in comparison to historical averages, but is likely to trend below the highs seen in recent years.

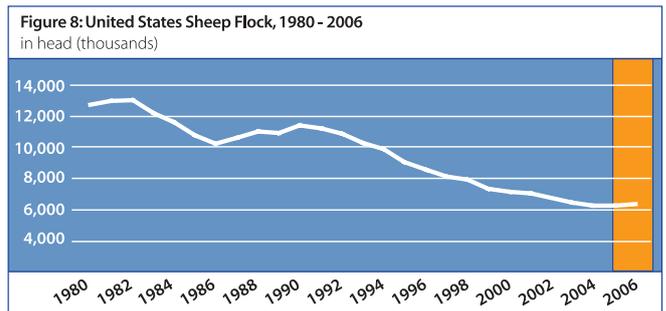
The United States has different market characteristics

Despite being the greatest meat consuming nation in the world, many Americans do not eat any lamb and per capita consumption is below the world average, at less than 1 kg. This is a negligible proportion of the approximately 120 kg of meat consumed annually per capita and compared to consumption of beef (~ 40 kg) and poultry (~ 50 kg). The US sheep industry was originally founded on the production of wool. With the decline in the demand for wool and falling wool prices post-World War 2, the US

sheep flock has steadily reduced. The reduced availability of sheep meat has occurred during a period of growth in meat consumption overall, particularly beef and chicken, and is therefore not a menu consideration for the majority of Americans.

Lamb and mutton consumption in the US is mainly split between ethnic niche markets and the high-end consumer markets. A USDA report notes that “the typical lamb consumer is an older, relatively well-established ethnic individual who lives in a metropolitan area like New York, Boston, or Philadelphia in the Northeast or San Francisco or Los Angeles on the West Coast, and who prefers to eat only certain lamb cuts.” These high-value consumers prefer lean racks, leg and loin cuts, typically in a restaurant setting, and there is minimal demand for the less desirable cuts. This consumer preference for only part of the carcass has made it difficult for domestic US sheep meat producers and packers to supply the market efficiently. However, New Zealand exporters have been able to direct the lower value cuts to alternative markets and made better use of the entire carcass.

The US sheep flock appeared to stabilise during 2005. For the first time in 15 years the flock increased by 2% and a greater proportion of ewe lambs have been retained for breeding over the past two years (Figure 8). This has translated into less domestic lambs available on the market in 2005 and 2006. A modest increase in production is expected from 2007 when additional lamb availability will lift competition in the US market.



Source: National Agricultural Statistics Service, Rabobank, 2006

The domestic sheep meat industry provides more than 50% of the US lamb market requirements, with Australia and New Zealand providing the balance. Over the past two years Australia has increased in importance. With tight lamb supply, New Zealand exporters diverted lamb from the US to try and fill their EU quota. Correspondingly, Australian producers have emerged from the drought and increased exports to the US to gain market share.

The US sheep meat market is not influenced by import quota restrictions and therefore exporters compete directly with local production. The US-Australia Free Trade Agreement has provided Australian lamb with a slight competitive advantage as the US\$0.7c/kg tariff has been eliminated. New Zealand’s lamb exporters continue to pay this tariff. However, New Zealand lamb has retained a higher average FOB price per kilogram over Australian lamb entering the US, despite lower export volumes from New Zealand in 2005.

US consumers have not escaped rising global lamb prices. Demand has continued at good levels due to higher beef prices in recent years and restricted lamb supply (both domestic and import).

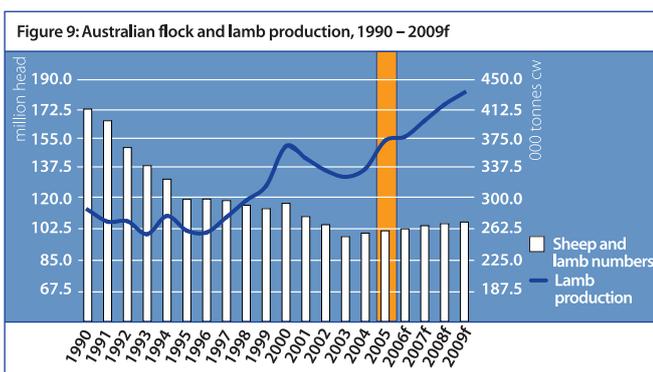
Wholesale prices for legs and racks supplied to the restaurant and food service sector were approximately 30% higher in 2005, than the previous year. Retail prices have also steadily increased over the past three years. In 2005, average retail prices for lamb exceeded beef by approximately USD2/ kg (USDA) and consumers began to consider alternatives on the restaurant menu and supermarket shelf.

While significant growth in US lamb consumption is not anticipated, market demand is stable and will remain dependent on imports. The US will continue to be a valuable, but increasingly competitive, market. Competition is expected primarily between New Zealand and Australian lamb exporters, as domestic production has a relatively modest impact. The preference for specific lean cuts of larger size and heavier weight in the US will be challenging for both consumers and producers in an environment where supply is relatively limited and world prices remain above historical averages.

The advance of Australian lamb – how big is the threat?

The Australian lamb industry shares many similar characteristics with New Zealand. The total sheep flock has declined by 44% over the past 15 years to approximately 100 million head in 2005. Declining returns for wool have led sheep farmers to reassess their business model and look for alternative income streams. Accordingly, income from sheep and lamb sales now accounts for 24% of total cash farm income for sheep producers in Australia, compared to a 6% contribution 15 years ago.

Australia's sheep flock has moved away from mature castrated males (i.e. merino wethers held for wool production) to a flock with a higher component of breeding ewes, able to be crossed with short or long wool rams to produce first and second cross prime lambs. Today ewes account for some 50% of the total flock and around 25% of these ewes are mated to meat rams. This move away from breeding solely for wool production is boosting production of sheep meat. As a result lamb production increased by 30% over the past 10 years to reach 375,000 tonnes in 2005 (Figure 9).



Source: ABARE, MLA, 2006

Lamb production is also meeting resurgent consumer demand, both at home and in export markets. With the demand for a larger, leaner product in supermarkets and some export markets the average carcass weight has increased from approximately 18 kg to 21 kg from 1996 to 2004. Producers have attempted to address lagging supply in 2005 to take advantage of higher prices through the winter off-season by a combination of later joining

to produce a later drop, combined with increased grain finishing. This significantly dampened the winter price spike that was seen in 2004. However, these trends bode well for the Australian lamb industry being increasingly able to offer export and domestic consumers a consistent high quality product all year round and reduce the traditional seasonality in supply. This smoothing of supply will also provide enhanced processing efficiencies through better year round utilisation and improved ability to hold skilled workers.

The domestic market for lamb in Australia is a key differentiating feature for the industry, compared to New Zealand. While New Zealand's sheep meat production has always been primarily destined for export markets, Australia has a domestic focus. In 1990, Australia exported only 14% of lamb produced, in 2004 this had grown to nearly 40% and is expected to grow further as lamb production increases and new export markets are pursued. The domestic market will continue to be a driver for the Australian industry as demand has remained strong despite the rise in retail prices over the past five years. A robust economy, improved product quality and presentation, consumer education and health benefits of lean red meat consumption have all contributed to the Australian lamb story.

Australia's lamb export activities are focused on the US and Asian markets. The US market accounts for 41% of Australia's export lamb value and has been increasing steadily. Growth has been a direct result of presenting a product that meets US consumer requirements – lean and large racks, loins and leg cuts and the development of strong supply chain alliances through to retailers. Japan has also been a growth market for Australia with the value of exports increasing by 48% in 2005 due largely to the scarcity of beef in the market following the exclusion of US beef imports in 2004. Japanese consumers have been repeatedly jolted by various food safety and animal health scares over recent years, such as e-coli, FMD and BSE in beef, FMD in pork and now bird flu in the poultry industry. Lamb has provided a high quality, nutritious, naturally raised, disease free alternative for Japanese consumers.

As New Zealand's key competitor in export markets, the Australian sheep meat industry has the potential to alter market dynamics. While Australia's small EU quota currently limits competition in that region, competition is expected to intensify in other important markets. With a sheep flock two and a half times larger than New Zealand's, Australia has the ability and resources to challenge New Zealand in markets for lamb. Meat and Livestock Australia forecast a 5% per annum expansion of lamb production through to 2009, which would see Australia's lamb production volumes reach close to 450,000 tonnes carcass weight. Australia will face challenges to achieving this growth through periods of drought, seasonal variances and lower lambing percentages. There is also room to improve production efficiency throughout the supply chain. Nevertheless, New Zealand sheep meat producers should remain aware of the development of Australia's prime lamb industry and expect increased competition in export markets from a near neighbour and rival.

Productivity and brand image lead the way for New Zealand

While New Zealand's total sheep numbers have declined from the mid 1980s peak of 70 million to 40 million today, its global reputation as the land of premium lamb remains largely unchallenged. This strong brand positioning in the global market continues to hold the industry in good stead and is further underpinned by:

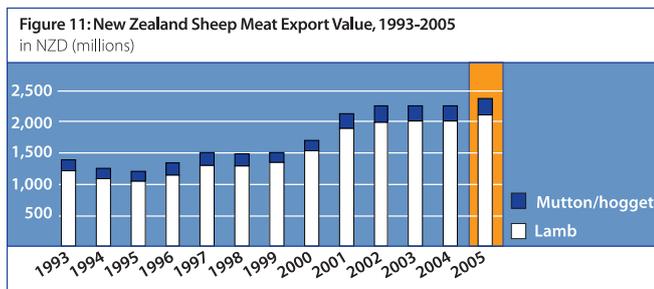
- New Zealand's dominance of more than half of the traded sheep meat market and 75% of traded lamb, exporting over 90% of annual domestic production;
- development of the generic New Zealand lamb brand in premium markets;
- a strategy to increase export value through chilled and value added cuts, especially lamb;
- productivity gains achieved by New Zealand farmers, particularly during the 1990s, that has enabled maintenance of production levels, despite the reduced flock size (*Figure 10*);
- EU quota access held through historical links with the United Kingdom.

Figure 10: New Zealand Sheep Industry Productivity, 1983/84 and 2004/05

	1983/84	2004/05	Change
Lambing percentage	103%	123%	+ 19%
Average lamb weight	13.6 kg	17.5 kg	+ 29%
Total sheep flock	69.7 million	40.1 million	- 42%
Total sheep meat production	644,000 tonnes	517,000 tonnes	- 20%
Total lamb production	472,000 tonnes	438,000 tonnes	- 7%

Source: MAF, Meat and Wool New Zealand, 2005

The substantial productivity gains achieved by New Zealand sheep farmers has driven the resurgence of the industry in New Zealand and increased profitability for all of its participants. As the largest agricultural sector at the time, the sheep industry felt the sharpest edge of domestic policy and market reforms of the mid-1980s. While this undoubtedly led to tough conditions for many farmers and a reduction in the national sheep flock, the resulting change in farming practices and efficiency gains have created a robust and thriving industry. The competition for land use in New Zealand that resulted in many sheep farms being converted to dairying in the late 1990s has also spurred further innovation and a focus on profitability within the pastoral sector.



Source: Statistics New Zealand, Rabobank, 2006

The importance of the sheep meat industry to New Zealand's agricultural economy is second only to dairying and provides

NZD2.4 billion in export earnings per annum, accounting for 8% of total export value. This is an increase of over 80% in the last 10 years and has been largely provided by the growth in lamb exports, which comprise around 90% of export value (*Figure 11*). The size of the sheep flock and production volumes are expected to increase further in 2006 due to favourable seasonal conditions and a modest upward trend in total ewe numbers over recent years. In the medium term, production volume growth is likely to be limited to on-farm productivity gains, as domestic competition for land use remains strong and limits significant expansion.

On the processing side, efficiency and productivity has resulted from rationalisation and the need to address overcapacity issues as the industry restructured through the 1990s. Advances in technology have enabled staff numbers on a processing chain to be almost halved over the past 20 years. The introduction of computer scanning of carcasses and mechanisation has also enabled improved quality and consistency of product. Processors are currently faced with the challenge of communicating market and consumer demands to the farmer to enable production of an animal that meets defined characteristics.

Additional productivity improvements will be required to ensure that processing of red meat carcasses, like lamb, does not further lag the efficiencies achieved in the pork and poultry sectors. The production of pork and poultry benefits from a quick growing cycle, able to adapt quickly to market demands, combined with a relatively uniform carcass composition for maximum processing efficiency. While the price differential between lamb, beef and other animal proteins reflects some of these variables, the gap must not become too great for consumers or producer returns will be affected.

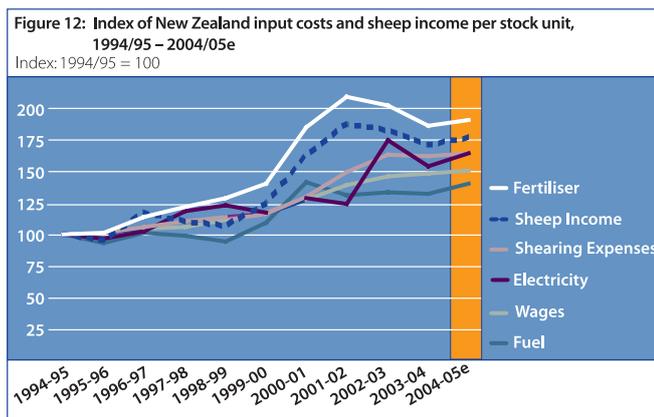
The development of higher value markets has been part of the transformation of the New Zealand sheep meat export industry. The early method of 'disposing' of sheep carcasses via the only avenue available – frozen and shipped to the UK – has been replaced by technological developments that enabled chilled boneless product to be exported and more sophisticated marketing. Early development of the country-of-origin brand for New Zealand lamb has provided a point of differentiation and effective market positioning of a high quality product. The success of this brand can be quantified in the premium obtained in export markets above product from other countries. Nevertheless, with increasing competition from other animal proteins, further development of the brand and value added attributes will be necessary.

The brand image of New Zealand lamb is also strong. In a world where the trade of meat products is increasingly dominated by disease outbreaks and trade bans, combined with consumers in high value markets demanding health and safety attributes such as leanness and animal traceability, lamb is standing out from the crowd. The natural characteristics of grass-fed lamb, the image and reputation of New Zealand's production systems and the ability to provide food security to consumers in export markets have been key driving factors for success of the industry in recent years.

Challenges on the horizon

While productivity gains have been nothing short of remarkable, continued on-farm growth at this pace is facing a head wind. Competition for land use remains strong and the need for innovation and improvement will be ongoing. Many of the challenges to productivity growth are not limited to the sheep industry, but nevertheless will need to be managed and overcome.

Rising input costs in the form of fuel, labour, land, fertiliser and compliance costs have been accelerating over recent years. However, the returns from sheep production have also increased. *Figure 12* shows that, with the exception of fertiliser, income from sheep production (meat and wool) has increased at a faster rate per stock unit than key input costs. The increase in total farm working expenses has also remained below income growth over the same period. While this indicates growing prosperity for sheep farmers, two important factors should also be considered. Firstly, this data doesn't include rising land costs, or the 2005 oil price increases that have negatively impacted both fuel and fertiliser costs. These costs are not expected to significantly fall in the near term. Meanwhile, record high international prices for lamb and mutton are easing. Secondly, the imbalance between wool income (-13%) and shearing costs (+64%) during this period is causing producers to examine where their farming system and product focus may be altered towards meat production.



Source: Meat and Wool New Zealand Economic Service, 2005

While increased net profitability has been evident within the sector, the inclusion of higher land costs into the equation places limits on the expansion and growth potential of the industry. Based on the Meat and Wool New Zealand farm survey, the average scale of sheep and beef farmers in New Zealand has increased 13% over the past 10 years to approximately 4,100 stock units. However, this has been largely achieved through intensification of production systems and more efficient and innovative management, rather than expansion of land holdings. For example, effective hectares farmed has increased 7% and stock units per hectare 6%, while tonnes of fertiliser applied has increased 70% during the same period. The most immediate challenge for individual producers is to determine where their efforts should be focused to achieve future growth.

Wool is now largely a by-product for many sheep farmers. Low international wool prices have added momentum to the number of producers switching to focus on meat production. Wool accounted

for almost 30% of average gross farm income in the mid-1990s; this has now dropped to 15% or below. The wool contribution to gross income for a South Island merino farmer is also expected to drop below 50%, from above 60% four years ago (MAF, 2005). The change in systems on-farm will increase both the production volumes of sheep meat and the demand for research and innovative management to adapt farming practices for meat production in areas that have traditionally been hill and high country merino land.

As producers have become more efficient, further lifting the productivity bar becomes increasingly challenging. Additional research to provide further productivity gains is continuing across the fields of genetics, disease management, pasture and feed production, amongst others. While this work will enhance the growth prospects for sheep farmers, productivity gains at the rate of the past 10 years should not be expected. For example, issues such as drench resistance have no easy solution yet can pose a significant constraint on farm production. Producers will need to be actively involved with processors and research bodies to:

- determine the basis for building future growth;
- assess how to continue the trend of productivity increases;
- ensure that sheep production remains an efficient and competitive enterprise.

New Zealand returns to the sheep's back

The New Zealand sheep meat industry has enjoyed a buoyant period of product prices over the past five years. This has enabled producers to reap the rewards of research, hard work, changes in farm management and structural adjustment in the industry since the 1980s. While global markets are currently adjusting to the vagaries of consumer demand and international product supply, the New Zealand industry should focus on determining the source of its next growth phase. Whether this comes from genetics, new technologies, different management systems or improved parasite control will depend on the choices of the individual business. However, ensuring New Zealand stays ahead of the competition in export markets will be reliant on retaining an edge in lamb production through production and processing efficiencies.

By holding firmly to a dominant and reputable position globally New Zealand lamb producers can look forward to continued solid demand for their product internationally. Reduced local production in the EU and steady demand in the US, combined with increasing demand from developing nations, will sustain the demand for lamb in the medium term. Meanwhile, top end consumers have demonstrated their resistance to very high premium prices, as the gap between lamb and other meats has widened. On the supply side, increased competition will be evident from Australian lamb and EU production is likely to be variable until farmers adjust to changes in the CAP. Overall prices can be expected to remain above long term averages as the world demand for meat protein rises with income growth, and increasingly a product with the natural attributes of lamb is sought by consumers.

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