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Competition, Deregulation and Opportunity

Seismic Shifts in Australia's Wheat Export Landscape

Rabobank International

Food & Agribusiness Research and Advisory

graydon.chong@rabobank.com
+61 28115 4091

www.rabotransact.com
www.rabobank.com/f&a

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Shifting export markets for Australian wheat have resulted in significant changes throughout the Australian supply chain, impacting industry participants from the farmgate through to ports. Over the past decade, increasing low-cost wheat exports from the Black Sea region, deregulation of the Australian wheat industry and strengthening demand from Asia have resulted in a seismic shift in the Australian wheat export landscape. Blending practices, logistical movements and the varieties of wheat planted have all changed as a result of these market adjustments. The ability of Australian wheat producers, grain marketers and bulk handlers to respond to these trends is integral to the success of Australian wheat exports in a rapidly changing environment.

Introduction

Australian wheat export flows have experienced a seismic shift over the past decade, resulting in structural changes along the supply chain. From the paddock through to bulk handlers and traders, the shift in demand for Australian wheat from traditional markets such as North Africa and the Middle East to the growing Asian market is resulting in change throughout the Australian grain industry. The demands of the Asian consumer are resulting in new seed varieties for grain growers, changing blending and storage practices for bulk handlers and the development of fresh trade links for the industry.

The rapid emergence of the Black Sea region[1] as the world's low-cost wheat supplier has contributed significantly to this shift in the Australian wheat export programme. Improved quality, coupled with production and logistical cost advantages have seen Black Sea region wheat displace Australian exports in many of its traditional markets over the past decade. While reliability of supply continues to impinge on the region's market share, longer term projections that Black Sea region wheat production and exportable surpluses will further expand only makes it more important for the Australian wheat industry to develop alternative market opportunities, such as Asia.

Deregulation of the Australian bulk wheat export market has played a major role in the shift in the client base of the Australian wheat industry. Increased participation by global grain traders in the Australian wheat export market has resulted in Australian wheat being exported into new markets around the world and in particular Asia. The ability to adapt to the changes in end-user demand at a time of dramatic regulatory change has been crucial to the smooth transition towards a fully deregulated wheat export market.

Australian wheat producers and exporters will need to increasingly focus on meeting the demands of Asian consumers in order to ensure a sustainable business model moving forward. By leveraging the growth in geographically close markets to which Australia has a freight advantage and by providing product which suits end-user demand, Australia can limit some of the substitution risk experienced through greater competition from the Black Sea region in these markets.

Meeting Asia's needs

Shifting Australia's wheat export focus to Asia brings both opportunities and challenges. The quality demanded by the growing Asian import markets as well as their purchasing behaviour differs to that of more traditional markets serviced by the Australian wheat industry. As a result, the shift in end-user demand is impacting the wheat supply chain from the farmgate through to ports. These changes have an impact on many industry

[1] Russia, Ukraine and Kazakhstan.

participants, from grain growers making farming decisions about what to plant through to bulk handlers and grain marketers coordinating storage and logistics.

Incentivising change through the supply chain

China's increasing demand for feed grain is likely to be one of the key dynamics in Australia's evolving wheat trade flows over the next decade. In 2012, Australia exported over 2.2 million tonnes of wheat to China, a YOY increase of 1.4 million tonnes. The demand for feed wheat in the China market stems from the growing animal protein production and tight feed grain supplies throughout the country. This demand for lower quality wheat is quite different from demand for higher protein milling grade wheat, which is in demand for human consumption from the traditionally serviced markets.

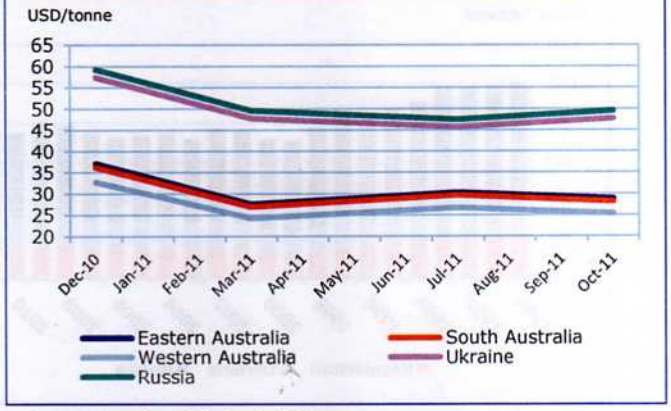
The shift away from supplying North African and Middle Eastern consumers has the potential to change the incentives or premiums on offer for Australian producers, and therefore impact the entire supply chain. For example, the differences in quality specifications demanded for the various markets have implications on the blending and segregation of wheat by bulk handlers and the premiums and discounts offered to growers by grain marketers. These price signals often result in changes inside the farmgate from the variety of seed planted to the amount of fertiliser applied and the types of chemicals utilised.

Developments in the Australian barley market provide a clear example of how changing demand needs in Asia are reshaping the Australian grains landscape. Australian barley destined for Asian markets has significantly increased over the past five years, with demand for food grade barley from the Asian market shifting the dynamics throughout the Australian supply chain. The strong and consistent end-user demand for food grade barley has resulted in grain marketers offering a premium for these varieties over feed barley. This has driven grower behaviour by incentivising the planting of increased acres of food grade barley varieties.

Price premiums for Australian noodle wheat destined for Japan, China and South Korea are another example of how end-user demand is incentivising change in the Australian wheat industry. Increased acres dedicated to noodle wheat and specialised segregations by bulk handlers can be attributed to the price premiums which are achieved by servicing this demand. Consistent price premiums for differentiated products are integral in developing change in the Australian supply chain. These price signals provide the link between market supply and demand, particularly for highly specialised products. Consistent price incentives will encourage a more reliable supply of noodle wheat from season to season and remove the volatility associated with production shortfalls.

Australia's geographical proximity to Asia provides a competitive freight advantage relative to other major grain exporting nations. Cost matters in emerging Asian economies and it is not only Australia's ability to produce wheat to meet the consumers' needs but also the ability to do so in a cost effective manner that is going to ensure the longevity of these trade relationships. Currently the largest destination for Australian export wheat at over 4 million tonnes per annum, the trade dynamics associated with exports to Indonesia are an example of Australia's favourable trade into Asia. Shipping freight rates for Australian exports into the Indonesian market are significantly lower than the rates for competing wheat originating in the Black Sea region (*see Figure 1*). The ability to supply wheat, which is consistently cheaper than competitors, to the growing Indonesian market provides a level of certainty to Australian exporters. Even in years of high global production and extremely competitive export markets, Australian exporters are able to remain suppliers of these Asian markets by virtue of lower freight costs.

Figure 1: Freight rates to Indonesia—Australia vs. Russia and Ukraine, Dec 2010-Oct 2011

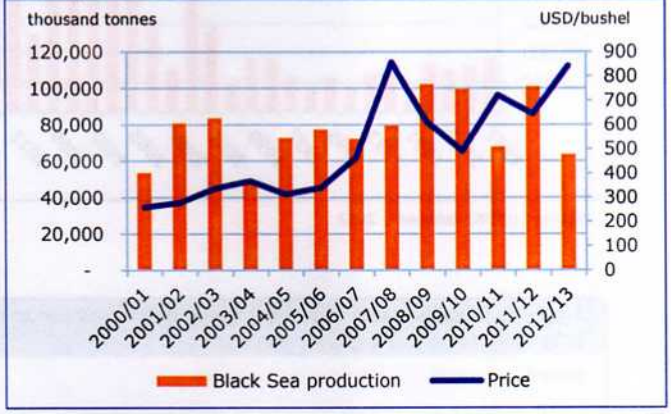


Source: Bloomberg, Rabobank, 2012

Increasing Black Sea region production key to displacement

A major contributing factor to the displacement of Australian wheat in North African and Middle Eastern markets and the resulting shift to supplying Asia has been the increased production achieved in the Black Sea region. The rapid rise in volumes produced throughout the region has changed the flow of grain globally and has caused price volatility throughout markets (*see Figure 2*).

Figure 2: CBOT Wheat prices and Black Sea production, 2000/01-2012/13

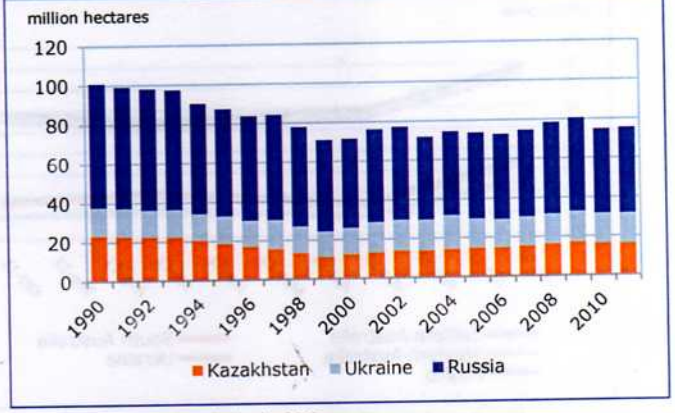


Source: Bloomberg, Rabobank, 2013

Black Sea productivity gains

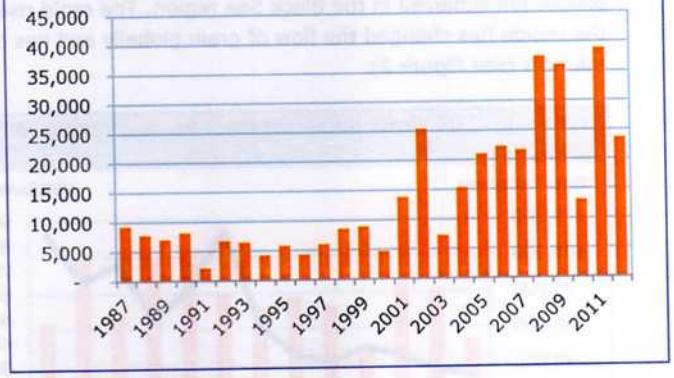
The adoption of better farm management practices by Black Sea region producers, as well as government investment in infrastructure, has contributed to both productivity and quality gains at the farm level. Increased production of wheat is primarily the result of improved yields as evidenced by the growth in overall grain production despite planted area remaining relatively flat (*see Figure 3*). Despite the seasonal variability, the Black Sea region has seen an overall increase in wheat production and exports since the year 2000 (*see Figure 4*). For the 10 years preceding 2000, the average wheat exports were just 6.17 million tonnes, compared to an average of 21.64 million tonnes from 2000 to 2012. Rapid production gains in wheat have made the region an influential player in global markets. Black Sea region wheat accounted for approximately 25 percent of the global wheat export volumes in 2011 and almost 18 percent in 2012 (*see Figure 5*). Representing such a large percentage of the global market, any disruption to the region's production has the ability to dramatically influence both world wheat prices and trade flows.

Figure 3: Total planted area (all grains) in the Black Sea region, 1990-2011



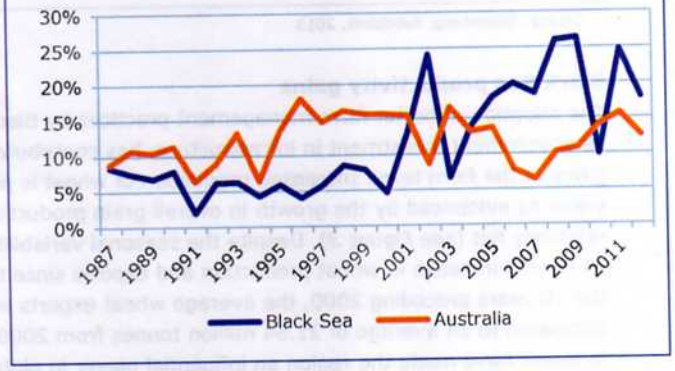
Source: USDA, FAS, Rabobank, 2012

Figure 4: Black Sea wheat exports, 1987-2011



Source: USDA, Rabobank, 2012

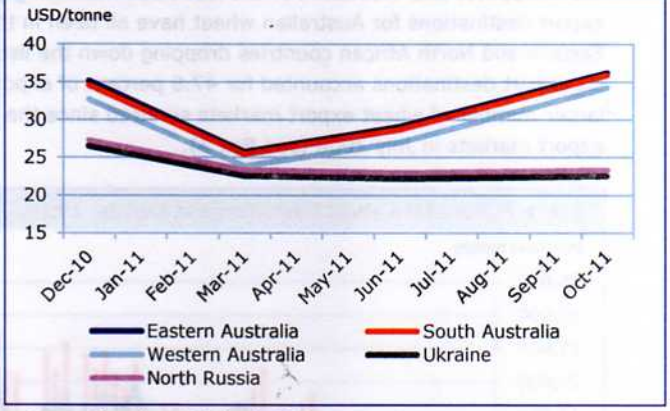
Figure 5: Black Sea and Australian wheat exports as percentage of total global wheat exports, 1987-2011



Source: USDA, Rabobank, 2012

Improving quality and yields have transformed the Black Sea region into a major source of grains for global consumers. Integral to the success of the region's wheat exports has been the lower cost of production and cheaper transportation costs into key Middle Eastern and North African markets. In years of high production, exports from the Black Sea region benefit from a distinct freight advantage over competing export origins, including Australia, into these markets. In 2011, Russian wheat exports totalled a historically high 21.6 million tonnes. Over the course of the 2011 marketing year, freight costs from Russia to Egypt were on average USD 10 to USD 15 per tonne cheaper than that of Australia (*see Figure 6*) The cheaper freight costs coupled with an abundance of supply gave Black Sea region exporters a competitive advantage in the Egyptian market, forcing Australian exporters to service the closer Asian consumers.

Figure 6: Freight rates to Egypt, Australia vs. Russia and Ukraine, 2010/11



Source: Bloomberg, Rabobank, 2012

Uncertainty causes volatility

The implementation of protectionist policy and food security initiatives has driven significant volatility throughout Black Sea region grain markets over the past decade. Wheat production by Russia, Ukraine and Kazakhstan was just 63.7 million tonnes for 2012. In comparison, the average production for the three countries between 2002 and 2011 was over 80 million tonnes. The highly variable production, caused mainly by inconsistent weather, has resulted in trade restrictions in the form of government export bans or duties in three out of the past ten years. The intervention, aimed at keeping domestic prices from rising in years of low supply, has had significant ramifications for countries that have increasingly relied on wheat imports from the region.

Reliability remains a challenge to the success of Black Sea region wheat exporters as long-term suppliers to the global market. Despite the recent droughts, which crippled export volumes and led to the implementation of trade restrictions, the ability to export relatively cheap, good-quality grain from the region is expected to drive strong long-term demand for Black Sea region wheat exports. With strong wheat production and export growth forecast for the region over the course of the next decade, significant logistical challenges are likely to arise. Stable export policy will be crucial to attracting the investment in logistical infrastructure required to deal with the increasing flow of grain via rail and port. Any incremental gains in Black Sea region production and competitiveness will have further impacts on global wheat trade and flow.

Changing Australian wheat export environment

The displacement of Australian wheat exports has taken place at a time of significant structural change in the domestic Australian wheat industry landscape. Deregulation of the export market, coupled with rising domestic production and stronger global competition, has increased the need and ability of Australian producers to service diversified markets. Growing demand from the Asian region coupled with an influx of export-focused grain marketers has led to the expansion into new export markets.

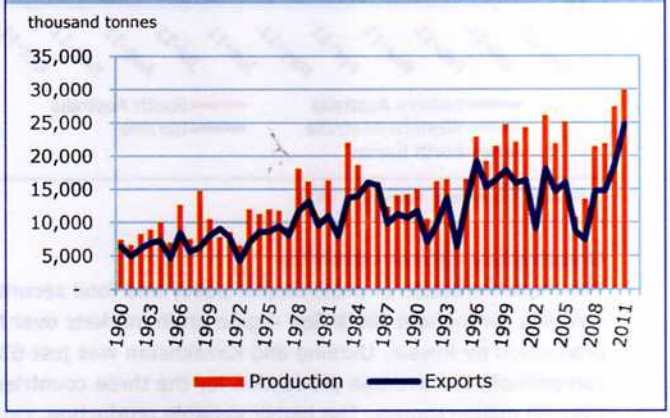
Developing new export markets

Reliable and consistent supply of Australian wheat exports, coupled with a reputation for high-quality production, has been crucial to the development of new export markets around the world. Prior to the 2012 season, Australian exports of wheat and flour increased over four successive years, culminating in over 24 million tonnes of exports in the 2011/12 season (*see Figure 7*). The ability to consistently supply high-quality grain exports has resulted in strengthening trade relationships throughout the Asian region.

Australia's shift towards increasing exports to Asia has occurred during a period of change in global supply and demand dynamics (*see Figure 8*). In the 2002/03 season, the top importers of Australian wheat included Indonesia, Japan, Iran, Iraq, South Korea and Egypt. These six countries represented 60.2 percent of total Australian wheat exports for that season. In comparison, the same six countries in the 2011/12 season represented just 39.2 percent of total wheat exports. The decline in market share is partly attributed to the displacement of Australian grain by exports from the Black Sea region into the Middle Eastern and North African markets. During the 2001 to 2012 period, Iran, Iraq and Egypt all

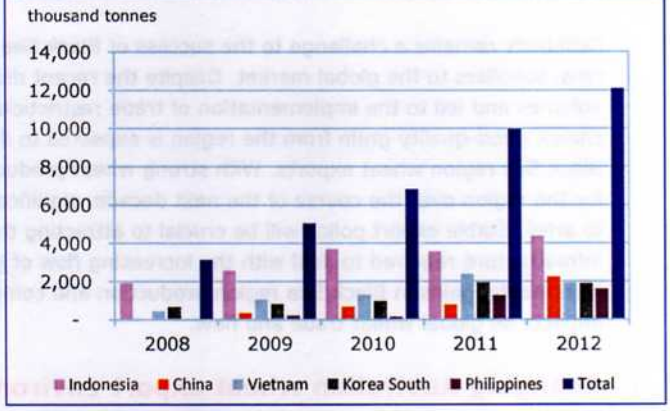
dropped out of the top six wheat export destinations for Australian wheat in favour of China, the Philippines and Vietnam. For the last three marketing years (2009 to 2012), the top five export destinations for Australian wheat have all been in the Asian region, with the Middle Eastern and North African countries dropping down the list. In the 2011/12 season, the top six export destinations accounted for 47.8 percent of exports, reflecting the impact of a larger number of wheat export markets serviced since the deregulation of the Australian export markets in July 2008 (*see Box 1*).

Figure 7: Australian wheat production and exports, 1960-2010



Source: ABARES, ABS, Rabobank, 2013

Figure 8: Increasing Australian wheat exports to Asia, 2008-2012



Source: ABARES, ABS, Rabobank, 2013

Australian wheat exports to Thailand, Vietnam and China have grown considerably over the past five years, accounting for over 5.5 million tonnes of the 25 million tonnes of wheat exported in the 2011/12 marketing year. After importing approximately 800,000 tonnes of Australian wheat in 2011, China imported over 2.3 million tonnes in 2012, a YOY increase of over 187 percent, albeit from a low base (*see Figure 9*). In comparison, the world's largest wheat importer, Egypt, decreased Australian imports by over 27 percent over the same two years, while importing over 1.9 million tonnes from Ukraine, or over 1 million tonnes more than the five-year annual average. The increase in Black Sea region exports to Egypt reflects the booming production seen in the region during the 2011 season. The excess supply flooded the export market with large quantities of cheap wheat, resulting in large imports by the likes of Egypt, Iran and Turkey. However, looking back a little further, the 2010 export ban, which was imposed by Russia and Ukraine to stop internal food price inflation, caused Egypt to source a larger amount of wheat from Australia. The resumption of wheat exports by both Russia and Ukraine in July 2011 allowed Egypt to return to importing larger amounts of the cheaper Black Sea region wheat throughout the 2011/12 season, thus reducing imports of Australian wheat. The displacement of Australian grain into the Egyptian market by wheat from the Black Sea region was the result of a combination of comparable quality and lower prices, aided by the significantly cheaper freight costs due to the geographical proximity. As a result, Australia increased its exports to Asian markets, such as China, Thailand and Vietnam.

Box 1: Developments in Australian export regulation

Wheat export volumes have been increasing at a time of rapid change in the Australian bulk wheat regulatory environment. The transition towards full deregulation of Australian wheat exports began in July 2008, with the abandonment of the Australian Wheat Board's (AWB) monopoly over bulk wheat exports and the introduction of the Wheat Export Marketing Act. The government established Wheat Exports Australia (WEA) to oversee the transitional period, with a view towards full deregulation. WEA's primary role was to administer the Wheat Export Accreditation Scheme, which required grain marketers wishing to export bulk wheat to meet specified criteria deeming them 'fit and proper'. As an independent statutory body, WEA had the power to issue and revoke export accreditations.

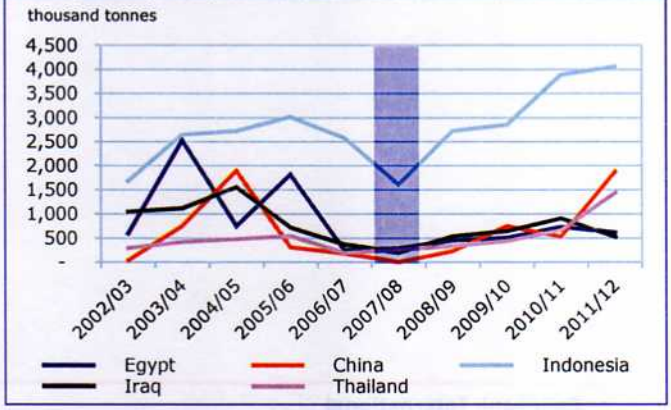
In December 2012, the Wheat Export Accreditation Scheme was abolished and replaced by the Wheat Export Marketing Amendment. As a result, WEA was closed on 31 December 2012 and some of the regulatory functions were passed to the Australian Competition and Consumer Commission (ACCC). At the time the WEA was disbanded in 2012 it had issued accreditations for bulk wheat export to 22 companies.

The transition from a single desk wheat export monopoly under the AWB to a deregulated market with 22 different grain exporters has changed the way in which grain marketing is now conducted. Australian growers now have more grain marketers to sell to than ever before, and as a result, Australian wheat is finding its way into new markets around the world.

The ACCC has been tasked with monitoring developments in the industry with the aim to remove port access tests and continuous disclosure requirements by 30 September 2014. The removal of these requirements is dependent on the development and implementation of a mandatory industry code of conduct, including plans for the equitable access to grain export terminals around the country.

The development of these industry driven initiatives and agreements will be closely watched as the market moves towards completing the process of going from a single desk monopoly to full deregulation in just six years.

Figure 9: Australian exports to selected markets before and after deregulation, 2002/03-2011/12



Source: ABARES, ABS, Rabobank, 2012

Conclusion

The shift towards supplying increasing quantities of wheat into Asia is forecast to provide new opportunities for the Australian grain industry in the long term. The cheaper freight costs into these markets offer a competitive advantage to Australian exporters, particularly in years of high global wheat production when there is additional export competition. The need to meet end-user demand in these markets will continue to drive changes throughout the Australian supply chain, particularly as the Asian market grows and consumer behaviour changes. The Australian market's ability to service the changing demand profile will be dependent on the right market signals being sent through the supply chain from bulk handlers and grain marketers.

At the farm gate level, the ability of Australian farmers to adapt to changes in market demands amidst a deregulation of the wheat export market has been challenging but productive. The responsiveness of growers to market signals regarding the quality, variety and types of crops demanded will be an integral part of the success of exports into the shifting global markets. For grain marketers and bulk handlers, the ability to meet the specifications required by new and developing export markets will be crucial. Developing trade relationships to better understand the volume, quality and timeliness of end-user

demand, and effectively passing these messages through the supply chain in the form of price incentives is integral to maintaining competitiveness in global markets.

The United States Department of Agriculture forecasts wheat exports from the Black Sea region to increase by 76 percent over the next eight years, bringing total wheat exports out of the region to 46 million tonnes. For Australia, the increase in competition in the global wheat export market will cause further shifts in trade dynamics, and will likely result in an increase in Australia's focus on trade throughout Asia. Ultimately, the industry's ability to adapt to the shift in trade dynamics in a rapidly changing regulatory environment will determine the future profitability and sustainability of the Australian wheat industry.

Rabobank International

Rabobank Food & Agribusiness Research and Advisory Global Grains & Oilseeds Sector Team

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

Chile—Valeria Mutis
valeria.mutis@rabobank.com

Indonesia—Pawan Kumar
pawan.kumar@rabobank.com

Argentina—Paula Savanti
paula.savanti@rabobank.com

China—Daron Hoffman
daron.hoffman@rabobank.com

Mexico—Pablo Sherwell
pablo.sherwell@rabobank.com

Australia—Graydon Chong
graydon.chong@rabobank.com

EU—Vito Martielli
vito.martielli@rabobank.com

US—William Sawyer
william.sawyer@rabobank.com

Brazil—Renato Rasmussen
renato.rasmussen@rabobank.com

EU—Bryan Willey
bryan.willey@rabobank.com

www.rabobank.com