Paper No 528

"The Harvest Report" Jon Tanner

Good Afternoon. I am delighted to be here speaking to you today representing the milling industry and to have the opportunity to update you on events around the 2006 Harvest. I would also like to draw on a couple of words from the Society's motto, so I hope to inspire you to some degree in the next half hour and the minimum I hope will leave a little bit more enlightened about this years harvest.

I'm sure a few of you are thinking what on earth is a sales and marketing proponent doing here to talk about the technical aspects of this years wheat crop. So maybe I should start by contexting my involvement in our business and explaining how Rank Hovis fits into the RHM Group. If you had a chance to read my epitaph in the programme you will all have noticed that I have spent the last 15 years or so working my way up the food chain from a farming background through grain and agricultural commodity trading to milling and baking with RHM. I found the transition fascinating and in fact a significant proportion of my working life is now spent alongside our wheat buying team. As my end product and our businesses end product, flour, is basically made up of only two ingredients, wheat and electricity.

I thought it might also be interesting to take this opportunity to illustrate where Rank Hovis fits into the RHM Group as there has been some considerable change to our businesses over the last few years, not least with the return to public listing. RHM is one of the UK's largest food groups with a turnover of almost £1.6 Billion, operating across 50 sites with more than 15,000 employees. In fact on a statistical basis all but one or two of you in the room would have an RHM product in your kitchen cupboards, although I'll understand if it's not a loaf of Hovis! The Group is split into three divisions, culinary brands, cake and customer partnerships and bread bakeries. Bread bakeries division accounts for some 50% of the Group's turnover with cake and customer partnerships around 30% and the balance 20% being made up in culinary brands. Operating profit for the last financial year ending in April 2006 was up £15 million to £173 million in our first year of public life.

So a quick flash around the divisions - Culinary brands is home to some of the UK's favourite brands including Bisto, Sharwoods and McDougalls to name just a few. This part of our business is the clear brand leader in all of the grocery markets in which it operates and we also serve all elements of the foodservice sector with private label and branded goods. Our brands are RHM's lifeblood and hence the innovation pipeline is crucial to culinary brands success. We constantly seek to excel in the fields of products, packaging and advertising innovation. Sharwoods recent entry into the chips and dips market in the snacks aisle being a clear example of the businesses desire to explore new and exciting market places.

Cake and customer partnerships division combine two distinct business segments under one management team. The cakes division combines Manor Bakeries and Avana Bakeries who between them market about one quarter of the packaged cakes eaten in the UK today. I hope you recognise a number of Mr Kiplings exceedingly good products, I had to say that, and I guess the Cadburys brand speaks for itself. The Avana Bakery, based in south Wales, however specialises in celebration and bespoke cakes such as the Hedgehog cake you can see there and the M & S Tiramasu you can also see in the picture on the right hand side. If you haven't tried Tiramasu get down to M & S, its fab.

Ledbury Preserves makes mincemeat, jams and marmalades for Group and retail customers as well as the Atora Suet, whilst Charnwood Bakeries based in Leicester makes all the frozen pizza bases for Pizza Hut in the UK and a significant quantity of their European outlets also. RHM Frozen operates in the increasingly challenging arena of frozen meals and desserts utilising both RHM and key retailer brands. In RHM Ireland we have a distribution arm marketing both RHM and third party goods.

Closer to home now and on to RHM bakery division which is the UK's largest vertically integrated miller and baker. British Bakeries, the home of Hovis, Mothers Pride and Nimble produce around 16 million loaves a week from 15 bakeries delivering to over 9,000 retail outlets on a daily basis. The plant baking operation is complimented by the speciality frozen part baked products manufactured by Le Pain Croistillant at their bakeries in west London and across the channel RHM France produces artisan frozen bread and viennerosie for a mix of French customers and UK retailers.

Closing on the wheat link now Rank Hovis mills in the region of 1.1 million tonnes of flour per year produced from 1.5 million tonnes of wheat at 8 mills across the UK. The map here shows our current mill locations and I have also highlighted the sites which have closed over the past three years as I reference a little later. We produce more than 270

grades of flour for our customers and the business is complimented by Holgran and Maltings and ingredient additive specialist, and Fleming Howden which produces high quality confectionery mixes from its Edinburgh base.

Rank Hovis is the UK's largest miller with a market share of just over 26% and we now operate in a sector which is seen and is currently undergoing significant change. The last 15 years have seen the number of mills decline by almost one third and the past three years alone have seen massive industry realignment, with the emergence of ADM as a major UK player. Carrs Milling purchase of the German Meneba UK interests and Rank Hovis ourselves acquiring the assets of Finedon Mill two years ago.

2006 has already seen the re-entry to the free trade market place of Allied Mills and ADM announcing the closure of 2 mills, not to mention the `For Sale' sign being hoisted above Northern Foods milling division.

So what are the main events in this years harvest report !

I am going to begin at a world level before moving to Europe and finishing with the 2006 UK harvest quality and the implications for any users, that is you and I.

Fresh in our minds, although a distant memory looking outside today, is the heat wave the UK experienced earlier this summer. We were only a warm up act for the USA, whose wheat growing regions were hit hard by near desert conditions resulting in a 15% reduction in yields compared to the previous year. This was the first news that signalled the troubled year for the major wheat producing regions which has culminated in the US Department of Agriculture pegging world wheat production at 585 million tonnes. A staggering 30 million tonnes less than in 2005/6.

When played against annual world consumption we see the lowest stocks to usage ratio at 19% since records began in 1960. These figures fresh off the press from the SDA last Friday. Keeping the stocks to usage chart on the screen and playing on top of it hard red winter wheat price in the USA you can see there is a clear correlation between stocks and wheat price over the years. As the ratio has dropped the wheat price has gone up and you can see at the moment that very effect.

The strong US market has further been fuelled by speculative trading of soft commodities by large US hedge funds looking for fresh investment opportunities and vehicles and identifying the sector as undervalued. Exports are also a key driver and you can see from the trade flow map here that the matrix is indeed very complex. I have only included 5 of the major exporters and I would like to draw your attention to Australia who is currently staring down the barrel of a harvest barely 50% of that last year. You can see the importance of Australian exports into Asia and northern Africa and the latest projections have heaps more pressure on the world market.

To wrap up the world situation and just to add further grist to the mill, India have been a trade buyer for the first time in 6 years and there are strong rumours that Poland will be in the market for up to 2 million tonnes too to compensate for a poor growing season there. The result and affect that we have already seen and continue to see is a 40% rise in world wheat values.

As you can see from this thermal image of Europe it was just a little bit warm here too and you won't be surprised to see that with drought fears across France and Germany during harvest the values of German and French wheat tracked the US markets. July in the UK saw the hottest temperatures since records began in 1914 and the press soon identified similar trends for those happening across the Atlantic and in Europe.

I am not going today to enter the biofuels debate as I believe we are probably a couple of years away from a significant impact to the UK market. Nonetheless definitely one to watch for the future.

The UK market here showing group 1 milling wheat at the beginning of August has already started to mirror the US and as combines began to roll in southern England it became clear that we weren't to see the usual harvest dip. In fact the energy on-cost is still hitting the industry hard. Flour millers announced an intended increase of their flour prices.

Analysts soon made the logical association to the knock on effects for flour related products and the press were quick to run with the news of price inflation. As ever in the UK just as we were beginning to enjoy a proper summer, a sustained period of wet weather ensued and whilst the majority of wheat had been cut across the south and the midlands, large areas of quality wheat remained in the fields further north and started to suffer quality problems.

Not an inflammatory statement, you may not view the northern half of the country as a key cereal producing region but over one third of wheat is grown in this area and is of vital importance to northern millers and processors.

Jump forward four weeks into September and the markets continue to react to harvest progress and world markets bringing us up to the present. You can see that the wheat situation and likely knock on effects is still headline news here in the Financial Times and Daily Telegraph. In fact I opened the Financial Times today and there's a whole page highlighting still the world concern around wheat and other commodity areas.

In actual fact the UK supply and demand is not dramatically different from last year although yields are slightly down resulting in a slightly lower exportable surplus. You can see there 1.7 million tonnes down from 2.5. As an island exporter we are subject to external marketing movements hence the UK mirror in the upward movements of the traded grain exchanges. Here you can see that London futures values versus the same time last year for feed wheat shows a 40% increase on 2005.

I suspect you are reluctantly curious as to the affect that this market activity is having on flour prices and in fact latest traded values into the northwest suggest a year on year increase of some £45 per tonne on flour. As yet the milling industry strives to manage this price volatility and sustained raw material prices going forward could see further increases in coming months.

But on to this years crop in more detail. The-trend away from Group 1 varieties continued. Whilst an area of concern for the future and worthy of watching, the volume of quality Group l's and some high performing Group 2 varieties mean that we will have sufficient raw materials on the whole. The technical team at Rank Hovis collates representative samples of more than 5 million tonnes of wheat, roughly one third of the UK crop and compared to last year was largely similar overall quality situation. The only significant difference being the higher hagberg falling numbers, results of the early hot weather.

I am going to compete with Nigel Hunter now for the most complicated chart of the day and break the harvest down into the four wheat groups and I urge you not to try and take in all the data. The main trend as you split by group is a decrease in protein as you go down and that really is significant also at the time a which the wheat tends to be harvested with farmers tending to get the combines out on the most high value crops, i.e. the bread making wheats, early doors.

Total Group 1 proteins, the distribution is largely similar to last year and as we would expect.

Just breaking down regionally, if you look at the southern half of the country you'll see there is a good proportion up around the 13.5/14.5% area which is ideal bread making and flour gristing for bread making grades.

As you move further north, Yorkshire is a bit different and you'll notice from the previous chart where we're looking at 100/120,000 tonnes on the bars we drop down to 25/30,000 tonnes similar protein levels. As we go further north the situation gets slightly worse with much reduced volumes and this is an area of concern, especially for northern millers and processors.

Group 2 proteins are also lower than the rolling average but again not as significant as we would expect. The varieties tend to be harvested slightly later in the harvest programme.

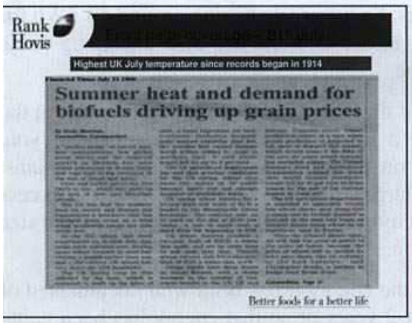
Specific weight or hectolitre weight also suffered in the early wheat with milling wheat crops being burnt up in the southern half of the country and as a result specific weights are somewhat lighter than last year. The results tend to be skewed by Malacca a class 1 milling variety which is well known for having a varietal trait for poor specific weight.

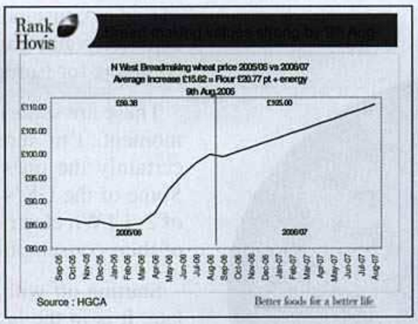
To summarise the entire quality picture, specific weight, protein and hagberg falling number you will see there is a substantial quality of wheat which can be used by the milling industry and we do not perceive availability, there may be the exception in the odd northern location, being of any real concern.

From a milling perspective we are experiencing no extraction loss at sites which is good news as we transferred to the new crop and that's been a very smooth process. Also water absorption is broadly similar, if not a little improved on flour, to last year. The low hectolitre weight which I mentioned will require a little bit of control but in general it is not seen as a major issue.

From a baking performance we see a slightly improved performance compared to last year. Some of the Group 2 wheat also looks good with Einstein, a fairly new variety performing much better than last year which gives us some confidence in offsetting the declining plantings in the group 1.

Looking forward to 2007, I have to say prices are expected to hold firm as a result of the tightening world supply and demand situation. Quality in general within the areas of the UK has been pretty good and I caveat that only with a slight eye open to the north.





Plantings next year are forecast slightly down for Group 1 quality wheat but overall plantings are seen up, probably by between 2-3% as farmers take advantage and get excited by the current high prices.

Interest in biofuels will increase as we go forward and it will be a headline agenda item I suspect in conferences to come as the renewable energy debate intensifies and the markets and crop will constantly provide a challenge to us and by default to yourselves that it is something we pride ourselves in mitigating on your behalf.

Thank you for your time.

Question: Paul Matthews, Shipton under Wychwood - We had a slight problem last year with farmers being disillusioned with milling wheat premiums and the problem we have in the industry is to really encourage farmers to grow the wheats that we need to use for milling flour for bread making purposes. What is your view of this year's premium overfeed? The feed market is very active this year as you can see and will continue to be active especially as biofuels kick in as well. Are you satisfied with milling wheat premiums or where do you think we ought to go, how do we get farmers to grow more of the wheat we need?

Answer: I think from a milling perspective, are we satisfied with milling premiums, yes we probably are. I think it's a fair representation of the current distribution and quality that we've seen in this year's harvest. How do we engage our growers in producing more for us, that is tricky and there is a clear balance and responsibility of our industry to provide a fair return for growing what is ultimately a lower yielding value. The current situation I guess and the upside for the grower is that some of these new varieties coming through, Solstice would be one, which I know that NABIM's wheat committee are taking a view on in the next few months with a view to upgrading that into a class 1 variety which would not only provide a higher premium going forward but is also a naturally high yielding variety as well so it should actually benefit the grower. So I would be confident that as ever that the market will find a value but there has to be a balance between buyer and grower to ensure that we get the products that we want and that will also dictate what the premiums are.

Question: Peter Jones, Cheshire - Excellent presentation. You could look on the climatic changes as a freak in 2006, I guess we are all aware it's getting warmer and some of the underlying factors are going to be there in abundance for future years as well. Have you any thoughts about predictions for the next 2 or 3 years?

In general I'm not going to try and predict the climatic issue. Clearly we have had what can only be described as freak weather in parts of the world this year but I think what is clear and I touched on it and said I wasn't going to talk about it is that the biofuel debate is huge. I think that the UK is some way behind Europe in parts and certainly the States and some of the statistics for inclusion of wheat and/or rapeseed or other agricultural commodities in biofuels is absolutely staggering and you can see the exportable surplus currently which we have in the UK, anywhere between 1.5 - 3 million tonnes in an average year being snapped up for inclusion in everyday fuel move to something like 1.5%, I think the number is. It is a staggering potential impact. You also have the business, Cargill, my former employer, has just commissioned a new plant at Trafford Park Manchester for starch and they are looking at an annual wheat usage of 750,000 tonnes and this years exportable surplus of 1.7 million, so almost half going to one new facility. So there are definitely some significant events on the horizon and as I said, I think in 2 years time you'll see biofuels really pushing to the front and revolutionising the agricultural quality market.

The other big play which may yet come and we've seen it this year is the financial institutions. The American markets have long been traded by hedge funds and financial institutions hence Chicago's mechanisms for protecting itself with a limit up and limit down mechanism on a daily basis and I think there is a realisation that soft commodities in general, not just wheat but agricultural commodities in general are seen by some analysts as undervalued which is potentially bad news for input costs for myself and you guys, but it also means we will see further volatility put into the market place by these financial institutions, so definitely one for the risk management could be a key issue going forward.

Question: Peter Jones, Cheshire - I agree with you and those are the points I was taking for granted, it was what is the impact of that likely to be, because its the law of supply and demand therefore prices will rise but actually supply in itself might be a problem to people trying to making a living out of making bread I guess?

Answer: I guess so, ultimately I guess the consumer pull through will determine that in the purer sense how much they will pay for a product they really want. There's certainly an argument for saying yes we are going to be looking at a sustained period of increased input and raw material prices, I can't dispute that. That being said we are currently right in the flood of every potential problem being thrown at us and what's not there is fact, its rumour and speculation. So if you return to a couple of years previous where we saw a world crop, 650 million tonnes, that puts a different perspective on the situation. So I can't give you a defined answer but it's certainly wise to keep an eye on and all the information at the current time points to increase volatility and potentially raised prices.

Question: Andy Pollard, East Yorkshire - Taking that a bit further and I know you probably can't give an answer on this one, you can give a comment. Obviously there's a lot of setaside land about, do you see the actual nature of farming changing?

Answer: I do, I think it's already changed to some extent in the last few years. The much talked about decoupling of subsidies from crops to basically single farm payments means that farmers not being subsidised for growing specific crops without being subsidised in effect for farming which means that the draw for growing certain crops and not growing certain crops is much more likely to be linked by the price of those commodities and the suitability of the farmers to try and grow them. So I think you will see a changing farmscape. I think you will see increased tension to environmental farming methods and there is an initiative called `Leaf' which has

been out some years which is linking environments and farming which a proponent of growing natural borders round fields for example to increase wildlife, whereas previously it may not have been in the farmers interest when he was trying to optimise his yields from a growing field that may not be quite such a priority, so you might see a slightly greener flipside to that as well. And there's much taut phrases `farms are becoming gardens of the countryside again'.

Question: With the supply potential issues that we are seeing here, how do you see the competition for growing organic in terms of value competing against standard common wheats that are being grown when we actually move to a net import position with biofuels?

Answer: That's an interesting one as well, isn't it? I think the organic market place will continue to grow I think as people look for healthier lifestyle products and focus more on the quality and provenance and also potentially the food miles debate about sourcing ingredients locally as well. And I think that it will ultimately again be determined by the volumes at which the products start to trade. At the moment there is a clear premium and there is a clear specific traceable supply chain for organic products. I'm not sure where the tipping point is to be honest as to how much organic has to grow before it becomes more in line with your main stream normally produced quality wheat. I suspect there's a fair way to go in volume terms. It would be interesting to see as well if organic can maintain its premium if we see rising wheat prices on the back of alternative uses.

Question: Andy Pollard, East Yorkshire - Probably a touchy subject, but what about the GM issue if wheat is going to be used as a biofuel basis, is that going to open up an opportunity for genetically modified crops?

Answer: I'm going to duck that one Andy. I don't know is the honest answer. I was involved when I was with Cargill at the time GM was heading the headlines in the mid 90's with Monsanto really pushing forward the agenda and it was interesting, and from a personal perspective I learned an awful lot. Personally speaking as an individual I don't hold a fear but a lot of the UK consumers generally do. I think that the marketing at that time didn't quite hit the mark and if you look at the USA there is not such a serious concern among the consumers, they are not so aware and it certainly has not been Frankenstein fooded as was the popular phrase. So for the UK I don't know, I'm sure at some point in the interest of science and optimising food production that at the end of the day consumption is forecast to outgrow production at the current levels. In the future that debate will be reignited. I am sure there are companies investing lots of money behind closed doors still in preparation for that time.