DAIRY INNOVATORS

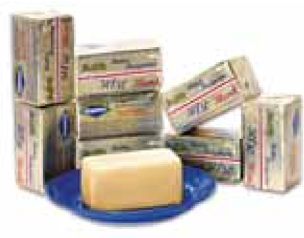
Not everyone is distressed with the Canadian Dairy Commission's remarkable nine per cent hike in support prices for butter (and 6.1 per cent increase for skim milk powder) that came into effect in February. Historically, demand shifts from butter to margarine when the price spread expands. The Canadian Dairy Information Centre notes that in 2001 the premium for butter, relative to margarine, increased seven per cent to $1.77 per pound, and butter consumption declined one per cent over the next 12 months. Butter consumption recovered in 2003 as prices of butter and margarine rose in tandem. Meanwhile, public concerns about trans fats contributed to a two per cent decline in margarine consumption in 2003.

Across the board, introductions of healthy new products heat up a competitive sector

BY DOUG BURN

During 2004, all the major margarine brands eliminated trans fats or introduced trans fat free alternatives. Although the full year results show a one per cent decline in unit sales, anecdotally it appears that margarine sales were bouncing back in the last half of the year. This year, with the lustre back on the low-fat low-cholesterol margarine and an expanding price spread with butter, margarine sales are set to soar. The price spread for Sobeys' retail brands of butter and margarine in Quebec in March was $2.70, a 40 per cent increase from the $1.90 spread reported by the Dairy Information Centre for all brands and banners across Canada in 2003.

Butter/margarine blends may set the pace for category growth thanks to butter's latest price hike and the recent opening of the Ontario market to dairy analogs and dairy blends. In the face of pressure from B.C. and Alberta to eliminate restrictions in accordance with the Agreement on Internal Trade, Ontario repealed its *Edible Oil Products Act* in December effective Jan. 1.



That's great news for Calgary-based Foothills Creamery Limited, which introduced Canada's first butter-margarine blend since a Saskatchewan dairy withdrew from the blend market many years ago. Foothills introduced its Foothills 50%/50% blend of butter and canola oil a year and a half ago. "Blends only became legal in Alberta five years ago and we saw an opportunity," says part owner and director of marketing Barry Northfield. Northfield notes that his blend sales rise every time the price of butter goes up because Foothills 50%/50% costs 30 per cent less than butter. Currently Foothills has distribution throughout the four western provinces and is looking eastward with the opening of the Ontario market. Quebec's market is still closed to blends but Atlantic Canada markets have opened up. Northfield expects Ontario grocers to be as receptive as those in the markets he now serves because "butter is typically sold as a loss leader and with our product they can make a profit."

Double Digit Organic Growth

Organic milk and dairy products are going mainstream with the launch of President's Choice Organics butter, cheddar cheese and skim milk in Loblaws Supermarkets, and the Ultima Foods' purchase last October of Delta, B.C.-based Olympic Dairy Products Ltd. "We acquired Olympic Dairy as it is a regional leader in organic yogurt and a producer of a variety of other dairy products including sour cream, organic fluid milk and soy yogurt," says Gerry Doutre, president and CEO of Longueuil, Que.-based Ultima Foods Inc., a Canadian leader in the yogurt category with its Yoplait brands.

Doutre notes that along with Olympic Dairy's new plant (built 2002), modern equipment and in-house lab, the acquisition "gives us exposure to the organic niche, which currently accounts for about one per cent of Canadian yogurt consumption."

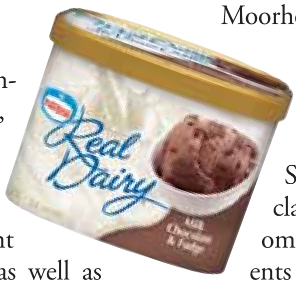
The dairy producers are keen to grow that niche as organic raw milk commands a 20 per cent premium over conventional milk. Alain Bourbeau welcomes the growing shelf space that grocers are dedicating to organic dairy products and particularly the Loblaws addition of its PC Organics Salted Fresh Churned Butter. Bourbeau, director, economic studies, for the Longueuil, Que.-based Fédération des producteurs de lait du Québec, says, "When a Loblaws promotes an organic butter, that benefits all our organic producers."

After 40 per cent annual increases in organic raw milk production since 2001, growth will slow to 12 per cent for the 2004/2005 dairy year based on year-to-date data from the provincial dairy producers' associations. While Quebec

(54 per cent) and Ontario (32 per cent) will remain the top two producers, B.C. should finish the current dairy year with a 15 to 20 per cent share of national production due to an aggressive expansion in its organic dairy herds.

Organic fluid milk should also win wider geographic distribution in 2005. In November, Organic Meadow of Guelph, Ont., one of the pioneers in the category, launched a new line of UHT certified organic milk in shelf stable Tetra Prisma aseptic cartons. While the costs of shipping fluid milk long distances remains a challenge, the extended shelf life of the carton will allow grocers beyond southern Ontario to develop the market for organic milk.

We all Scream for ... Omega-3?



In 2004 the ice cream category got carb conscious, expanding its range of reduced sugar, no-fat and low-fat products. Good Humor-Breyers Ice Cream from Unilever introduced Breyers Smart Scoop, a line of frozen desserts, yogurts and novelties with 98 per cent fat-free, low-fat or no sugar added choices, as well as Breyers Smart Scoop Carb Zone frozen desserts and novelties. Nestlé launched REAL DAIRY with a similar range of ice creams and frozen desserts featuring reduced fat and low to no added sugars.

This March, Nestlé upped the good-for-you ante with the launch of REAL DAIRY with omega-3 fatty acids. Karin Moorhouse, marketing vice-president, Nestlé Canada ice cream, explains that while many ice cream lovers are trading up to premium and super premium high-fat products and reducing the number or size of their servings, many others are looking for healthier options such as sherbets and low-fat, low-sugar ice creams. This is particularly true, she adds, in the novelties category. "For moms, we offer portion control novelties such as REAL DAIRY Yogurt Smoothie Bar Minis and better-for-you ranges such as REAL DAIRY No Sugar Added. So it's a treat for their kids and for themselves."

Moorhouse cites an ACNielsen MarketTrack that showed good-for-you and wholesome novelties accounted for one in five purchases in 2004.

At the same time, Stoney Creek Dairy, a privately-owned maker of ice cream and novelties in Stoney Creek, Ont., launched Naturelle Plus, which claims to be "the first all natural ice cream with omega-3 fatty acids." Made with only natural ingredients and no artificial flavours or colours, Naturelle Plus is a premium ice cream produced with cream from cows that are fed a unique diet enriched with omega-3 fatty acids.

Stoney Creek's general manager Alex Kepecs says, "Utilizing omega-3 rich cream produced naturally by

Canadian cows lets us satisfy our consumers' cravings for a great tasting product that meets Canada's standards as a source of omega-3."

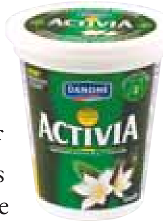
Yogurt and Probiotics

When Ultima Foods launched its new Yoplait.ca website in February, Yoplait Basket Fat-Free was repositioned to emphasize its probiotic properties. Gerry Doutre, Ultima's president and CEO, explains, "We didn't originally make a big issue of its probiotic properties. Rather we emphasized its flavour and fat-free characteristics." The repositioning, accompanied by an "Active bifidus Probiotic" flash on the new packaging, was triggered by the remarkable success of Danone's Activia, which was launched in Quebec in May 2004 and launched nationally early this year. Activia is promoted as "Canada's first and only scientifically proven probiotic yogurt with unique (*Bifidobacterium lactis) B.L.* culture."

Doutre explains that probiotic yogurts are well established in Europe. Activia, for example, has been sold in the European market since the late '80s under the brand BIO*. When Ultima launched Yoplait Basket Fat-Free in 1995 there was little awareness or demand for probiotics in Canada. All that changed in the summer of 2004 as influenza spread throughout Quebec. The province reported 303 cases in the last half of the year, more than double the number reported in the same period a year earlier and three times more per capita than the rest of Canada. Consumers sought out Activia for its advertised digestive health benefits and sales soared.

Tom Pugh says, "Our sales of Activia in Quebec outperformed our wildest expectations. Sales are snowballing week by week. Consumers love the taste, texture and the health benefits." Pugh, marketing director for Boucherville, Que.-based Danone Canada, took Activia national in January.

Probiotics offer three distinct advantages for yogurt makers: they command premium prices and higher margins (eight 116 gram containers of Activia retail for $4.99), they open up the previously underdeveloped yogurt market among older Canadians and, Pugh adds, "because of the health benefits probiotics prompt consumers to eat more on a daily basis rather than occasionally. Until now, no one saw the need to eat yogurt every day. The target demographic are those Canadians concerned about their physical health in general and their regularity in particular so it's primarily those consumers over the age of 30," notes Pugh. "As compared to high fibre cereals, Activia is a tasty alternative."



DHA Raises the Bar for Omega-3

Natrel pioneered the market for omega-3 dairy products with the Quebec launch of Natrel omega-3 fluid milk in 2003 and the subsequent national launch of the product in Ontario and B.C. last summer. Natrel omega-3 and many other fluid milks and dairy products are produced by adding flaxseed oil or other omega-3-rich oils to milk at the dairy. Now, the cutting edge has shifted to DHA omega-3 milk, produced by feeding dairy cattle a patented diet rich in fish meal to produce raw milk with high levels of docosahexaenoic acid (DHA). DHA supports normal development of the brain, eyes and nervous system.

DHA omega-3 was developed at the University of Guelph with support from the Dairy Farmers of Ontario and is being commercialized worldwide by Oakville, Ont.-based Food Systems Innovation (FSI). Mike Ramsay, vice-president, business development for FSI, explains that the patent covers the feed and the feeding process because without a form of

Production and Sales of Dairy Products and Fluid Milk

Production of Dairy Products (Millions of Kilograms)

	Production 2004	CAGR* 2003 v.'01	Change 2004 v.'03
Processed Cheese	71.0	- 1.0%	+ 10.9%
Cheddar Cheese	124.3	+ 0.5%	- 6.1%
Mozzarella	118.4	- 0.7%	- 0.1%
Other Specialty Cheese	97.3	+ 4.3%	+ 8.6%
Cottage Cheese	26.3	+ 0.7%	+ 6.8%
Sour Cream	43.1	+ 2.8%	+ 1.0%
Yogurt	213.7	+ 9.7%	+ 8.1%
Ice Cream - Hard	284.5	+ 2.5%	+ 0.6%
Ice Cream - Soft	16.9	+13.6%	- 7.2%
Ice Cream - Mix	154.8	+ 3.0%	+ 2.7%
Sherbets	9.2	-20.8%	+54.0%
Water ices	19.8	+ 6.6%	+13.3%
Ice Milk Mix	33.0	+ 0.5%	- 4.3%
Milk Powder	114.8	- 1.3%	-13.9%
Evaporated & Condensed Milk	59.3	- 3.7%	-13.6%

Sales of Fluid Milk (Millions of Litres)

	Sales 2004	CAGR 2003 v.'01	Change 2004 v.'03
Milk 3.25%	418.0	- 0.8%	- 1.8%
Milk 2%	1,281.0	- 1.3%	+ 0.4%
Milk 1%	571.1	+ 1.4%	+ 3.4%
Skim	275.4	+ 0.8%	+ 1.9%
Chocolate	172.4	+ 4.8%	+ 7.4%
Total Fluid Milk (inc. Eggnog & Buttermilk)	**2,714.2**	**- 0.1%**	**+ 1.2%**
Cereal Cream 5% - 10%	102.2	+ 2.4%	+ 6.1%
Table Cream 15% - 18%	82.0	+15.8%	+ 9.2%
Whipping Cream 32% - 35%	263.3	+ 6.3%	+ 4.7%
Total Cream (inc. sour cream above)	**263.3**	**+ 6.3%**	**+ 4.7%**

* CAGR (Compound Annual Growth Rate)
Source: Dairy Information Section, Agriculture and Agri-Food Canada

encapsulation the DHA wouldn't pass through a cow's four stomachs and into the milk. Producers are compensated for the additional cost of the feed and paid a bonus to produce the milk. FSI has issued patents to dairy processors in Canada, the U.S., Europe, Australia and New Zealand.

Neilson Dairy of Georgetown, Ont., won the exclusive Canadian rights to DHA omega-3 milk last year and in April 2004 launched Dairy Oh! – what it called the "World's first fresh milk with 0.02 grams (20 milligrams) of DHA per serving" – and sales have been spectacular. Philippe Meyersohn, vice-president marketing, says, "According to ACNielsen, omega-3 accounts for 1.3 per cent of the fluid milk sold, that's a higher share of the fluid milk category than organic and calcium. Omega-3 milk is getting two thirds as much market share as lactose reduced milk. We already have a 93 per cent share of the omega-3 fluid milk category."

Neilson is now expanding distribution beyond its Ontario market. This April Dairy Oh! will be launched nationally in single serve plastic bottles. Because these are cold filtered milks, they have sufficient shelf life for national distribution. Meyersohn explains, "The April launch will include a packaging redesign for our current line (1%, 2% and homogenized) for a more consumer friendly look."

Parmalat was the second Canadian company to obtain exclusive rights for a DHA omega-3 cheese. In February, Parmalat launched Black Diamond D.H.A. Omega 3 Natural Cheese across Canada. At the same time it launched omega-3 (not DHA) Beatrice Omega 3 Milk Beverage, ASTRO BioBest Omega 3 Yogurt and Lactantia Healthy Attitude Omega 3 Margarine.

FSI is in negotiations to grant exclusive Canadian licences for DHA omega-3 butter, yogurt, ice cream and other dairy categories. FSI's Ramsay estimates the market potential for DHA omega-3 to be seven to eight per cent of the fluid milk and dairy product categories, the same share omega-3 eggs have achieved in the egg category. He notes that while DHA omega-3 dairy products command premium prices equivalent to those for filtered and calcium-enriched milk, both categories have been well accepted by consumers.

Consolidation Continues

In January, Agropur Cooperative and its fluid milk division Natrel acquired Island Farms, the Victoria-based dairy cooperative with plants in Victoria and Delta, B.C., and annual revenues of $93 million. The acquisition expands Natrel's sales by 10 per cent to $1,070 million.

Brampton, Ont.-based Arla Foods Canada Inc., a wholly owned subsidiary of Arla Foods amba Denmark, acquired Concord, Ont.-based National Cheese Company Ltd. in November. Arla Foods Canada, with a staff of 14, imports cheese and produces cheese under license in P.E.I. National Foods, best known for its Tre Stella brand, employs 240 personnel at two cheese plants in Ontario and also imports cheese primarily from Italy. The acquisition, according to the Arla Foods amba press release, will triple Arla's cheese sales in Canada to $170 million and, according to deputy managing director Andreas Lundby, "give us substantial import quota, which we'll use to sell more Danish- and Swedish-produced cheeses in the country."

Impact of CEM Program Closure On Milk and Dairy Food Exports*

		2001 Millions	2004 Millions	Change Millions
Milk/Cream Concentrated or In Powder	Exports	$202	$64	- $138
	Imports	$55	$63	+ $8
	Trade Balance	**+ $147**	**$ 1**	**- $146**
Cheese And Curd	Exports	$109	$77	- $32
	Imports	$199	$215	+ $16
	Trade Balance	**- $ 90**	**- $ 138**	**- $48**
Total	Exports	$311	$141	- $170
	Imports	$254	$278	+ $24
	Trade Balance	**$57**	**- $137**	**$ 194**

* The Commercial Export Milk (CEM) Program was ended December 2002 but contracts were allowed to continue through April 2003
Source: Statistics Canada, Trade By Product (HS) Codes

Canadian Retail Sales of Dairy Products By Selected Markets and Categories

	Retail Markets Code*	Value Million	Value Change Per cent	Volume Change Per cent
Butter	GGMW	$373.0	+ 3%	+/- 0%
Margarine	GB	$282.4	+ 1%	- 1%
Dairy Blends/Spreads	GGMW	$1.4	- 1%	- 6%
Processed Cheese Slices	GGMW	$242.0	+ 2%	+ 1%
Other Processed Cheese (including dips)	GGMW	$535.4	+ 5%	+ 4%
Prepackaged Cheddar	GGMW	$705.6	+ 10%	+ 7%
Prepackaged Specialty	GGMW	$591.5	+ 11%	+ 8%
TOTAL CHEESE	**GGMW**	**$2,074.6**	**+ 8%**	**+ 5%**
Fluid Milk inc. Specialty	GB	$1,778.0	+/- 0%	- 1%
Cream	GB	$195.9	+ 7%	+ 3%
Soya Drinks	GB	$88.5	+ 5%	+ 6%
Chocolate Milk	GB	$89.4	+ 7%	+ 5%
Yogurt In Tubs	PLUS	$710.5	+ 14%	+ 14%
Yogurt In Tubes	PLUS	$35.0	- 7%	- 9%
Drinkable Yogurt	PLUS	$36.0	+ 28%	+ 21%
Other Yogurt	PLUS	$86.5	+ 9%	- 2%
TOTAL YOGURT	**PLUS**	**$868.0**	**+ 13%**	**+ 10%**
Regular Ice Cream	GGMW	$419.6	+/- 0%	- 3%
Frozen Yogurt	GGMW	$29.5	+ 1%	- 3%
Sherbet	GGMW	$12.7	+/- 0%	- 5%
Other Ice Cream & Related	GGMW	$38.5	+ 33%	+ 15%
TOTAL ICE CREAM & RELATED PROCUCTS	**GGMW**	**$500.5**	**+ 2%**	**- 2%**

Code* GGMW: National Grocery, General Merchandise and Warehouse Club,
GB: National Grocery Banner.
PLUS: National Grocery, General Merchandise and Warehouse Club plus Mass Merchandisers.
Source: ACNielsen MarketTrack, 52 Weeks ending January 22, 2005

A More Competitive Market Ahead

Andrew MacGillivray expects 2005 to be more challenging than last year due to the recent hike in support prices for butter and skim milk powder and the ending of the Commercial Export Milk (CEM) program. MacGillivray, president and CEO of Weston, Ont.-based Gay Lea Foods Co-Operative Ltd. and chair of the Dairy Processors Association of Canada, explains, “The competition has become more intense as we are prevented by the WTO from exporting so everyone is focused on the domestic market.”

In December, for example, Agropur Cooperative laid off 50 employees with the closure of its Saint-Alexandre, Que., dairy. Louis Lefebvre, president of Agropur’s Industrial Division, explains, “The decision handed down by the WTO in 2002 (ending the CEM program) has significantly limited our export capacity.”

Noting the Canadian Dairy Commission’s decision last December to raise producer support prices for butter by nine per cent and skim milk powder by 6.1 per cent effective Feb. 1, 2005, MacGillivray explains, “The significant price increases in February are a particular challenge for commodity categories such as butter.”

Gay Lea is a domestic market leader in fluid milk, butter, cottage cheese and sour cream categories that are primarily sold on price and is a leading exporter of skim milk powder, which took the brunt of the CEM program closure. MacGillivray is meeting the challenge by reinvigorating the cottage cheese category where Gay Lea’s Nordica is the top selling brand.

“In January we launched our Running On Empty campaign for Nordica Cottage Cheese,” says MacGillivray. We believe cottage cheese is undervalued and the category is underdeveloped so as a leader in the category it is our responsibility to take the initiative.

Doug Burn is a Toronto-based freelance writer and editor.