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Firm prices anticipated

Our forecasts are unchanged at \$6.40/kg MS this season and \$7.30 next.

Dairy markets have strengthened over the past six months on the back of improved returns for dairy commodities and a softer New Zealand dollar.

Fonterra is on track to finalise its milk price for the 2018/19 season within its current forecast guidance range of \$6.30-\$6.60/kg milksolid (MS). Our forecast for this season remains at \$6.40/kg MS.

Stronger returns are forecast for the 2019/20 season. Our forecast for next season remains at \$7.30/kg MS. This price assumes dairy commodity prices will hold near current levels for the remainder of the 2019 calendar year, then ease slightly in the later part of the season. The exchange rate assumption is **aligned with ANZ's view that the NZD will continue to weaken against the USD, easing back to USD0.64 by the end of 2019.** We expect Fonterra will forecast a range of \$6.50-\$7.50/kg MS.

The exchange rate used in our forecast calculation takes into account **Fonterra's assumed hedging policy**, which implies a delay in the impact of movements of the NZD on the farmgate milk price. The effective exchange rate used in the forecasts is USD0.665. The 2019/20 forecast is based on a weighted whole milk powder (WMP) price of USD3140/t for next season. This is slightly below the price at which WMP is currently trading.

Figure 1: Farmgate milk prices, historic and forecast



Source: Fonterra, ANZ Research

Fonterra is expected to forecast a milk price range, rather than a single figure, for next season. This approach is designed to give its suppliers a more reliable indication of the risk involved in the forecast. A range of at least \$1/kg MS would be required to provide a reasonable degree of certainty that the final milk price figure will fall within this range.

Previous opening forecasts have varied from the final milk price by more than \$2/kg MS, but a forecast wider than \$1/kg MS provides very little guidance to suppliers. We may also see Fonterra deviate from its previous practice of providing equal upside and downside risk in its forecasts. Given

suppliers are more concerned with forecasts that exceed final payments we would not expect to see the co-op err on the side of caution. Weighing it all up, we expect Fonterra will forecast a range of \$6.50-\$7.50/kg MS for the 2019/20 season.

Milk price futures break \$7 mark

Milk price futures for the 2019/20 season, trading on the NZX Dairy Derivatives market, broke the \$7/kg MS level on May 10 and have continued to trade above this level. The daily settlement price peaked at \$7.06 on May 16. There are currently open positions held for just under 13 million kg MS for next season, as farmers look to hedge their milk price risk by locking in positions.

Fonterra is also offering a new fixed price milk programme for up to 5% of its milk supply. The new tool will have prices linked to the NZX milk price futures and will be offered on a monthly basis throughout the season, excluding January and February.

The main differences between the two schemes is the level of complexity and the cost. Farmers directly taking positions in the NZX Milk Price futures market must negotiate the complexity of margin calls (payments made or received as the value of milk price futures move on a daily basis) and must use a broker to access the market. While broker and exchange fees will apply, along with interest rate costs, these costs will typically be less than the 10c/kg MS fee that applies to the Fonterra scheme. The main advantage of the Fonterra scheme is that it is much simpler to understand and participate in.

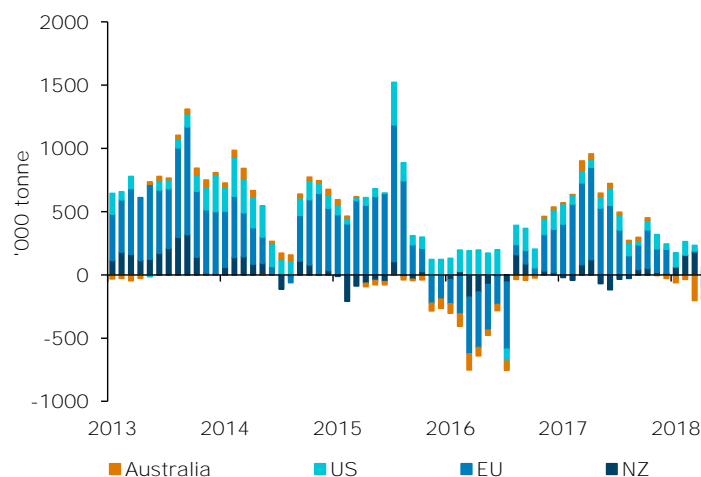
Easing of global milk supply drives prices up

Dairy commodity prices have trended up over the past six months, due primarily to tighter global supply. The upward price movement has steadied in recent months, but prices should continue to be supported as global milk supply growth is contained at levels that should be absorbed by normal demand growth.

Farm-gate milk prices are not strong enough in the major Northern Hemisphere dairy-exporting regions to stimulate additional milk production. There is a little more milk being currently being produced in parts of Europe, but volumes are not expected to be excessive.

Returns to New Zealand and Australian suppliers are expected to lift next season. However, a lack of confidence in the dairy sectors both here and across the ditch means higher revenue is not likely to drive additional milk production.

Figure 2: Milk production growth for major exporters



Source: ANZ, Dairy Australia, DCANZ, USDA, European Commission

Milk flows in the other major dairy exporting countries, Argentina and Uruguay, are also expected to remain in check, limiting global competition for New Zealand product. A surge in milk production is also not expected in any of the major milk-producing regions that also import large quantities of dairy products. This list includes China, Russia and Brazil. Russia is investing in dairy farms but is yet to see a lift in milk output.

In China, prices for protein have lifted in the wake of a reduction in pork production due to the spread of African Swine Flu. This is encouraging some of **China's small-scale** dairy farmers to cull their dairy cows, due to the high value of their meat. While there is also very little new investment in large-scale farms, China is now starting to invest in its medium-scale farms (up to 300 cows). Once, these farms were considered too small to receive the government subsidies that were lavished on the large-scale farms. But the value of these medium-scale farms is increasingly being recognised, as they are able to operate more cheaply than the large-scale farms and still achieve milk quality standards aligned with market expectations. However, despite this additional investment in medium-scale farms it is difficult to see China lifting its milk output anytime soon.

Demand-side risk remains

Global economic growth remains subdued, which has the potential to reduce international demand for dairy commodities. **In particular, New Zealand's** dairy prices have become very entwined with the fate of the Chinese consumer.

Thus far, although the Chinese economy is coming under some pressure, global dairy consumption appears to be steady, as is demand for other food products. Demand at the commodity level has also been bolstered by the erosion of the government-held stocks of skim milk powder that have overhung the European dairy markets since milk supply surged following the removal of milk price quotas in April 2015.

Global demand for dairy commodities remains robust, with whey (a by-product of cheese production) being the one exception within the dairy ingredients complex. New Zealand manufactures only small quantities of whey and the majority of this is used in high-end products, rather than whey powders. Global exports of whey primarily come from the United States and Europe. China has always been a big importer of low-grade whey products as pig feed, but the number of pigs in China is falling due to the spread of African Swine Flu. This **has reduced China's demand** for whey, mainly sourced from the United States. The resulting downward pressure on whey prices will reduce farmgate returns and hence production incentives for European and US dairy farmers.

All up, while there exists downside pressure on global dairy demand via potential weaker Chinese consumption growth, supply-side and structural offsets appear to be winning the battle thus far. We forecast this state of affairs to continue, **but it's fair to say uncertainty is high with the global outlook** delicately poised.

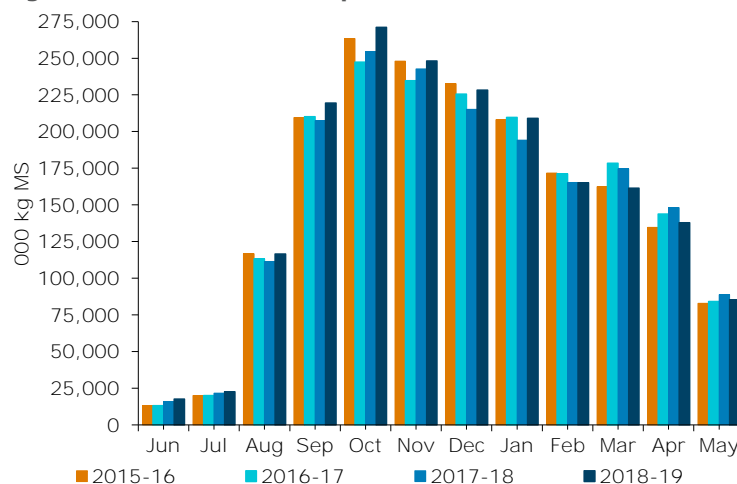
Solid production season

New Zealand is one of the only major dairy-exporting nations whose milk supply is actually growing. The growth in supply in the 2018/19 season (estimated +2.5%) has been due primarily to favourable weather conditions this season relative to last season, rather than investment. Spring conditions were favourable for growth, which set the season up well through the peak production from spring through to Christmas.

As at the end of December milk production was 5% ahead of the previous season, due partially to good growing conditions in 2018 and partially to the extremely poor conditions the previous spring, which resulted in higher year-

on-year growth than would otherwise have been the case. Conditions early in 2019 were drier than ideal in many regions, which saw production being trimmed back. However, autumn rains arrived early enough to set up many regions for favourable late-season production. The autumn of 2019 may not have been as good as the previous year, but that was always to be expected given the exceptional growing conditions that prevailed in the autumn of 2018.

Figure 3: New Zealand milk production



Source: ANZ, DCANZ

Yili's bid for Westland

A Hong Kong-based subsidiary of **China's largest dairy company**, Inner Mongolia Yili Industrial Group Co., Ltd (Yili) is the favoured buyer for Westland Milk Products. **A strategic review carried out by Westland's board last year** found that if they wanted to deliver a fair milk price to their suppliers they had little option other than selling the business. The company did not have sufficient capital and its high debt levels were crippling its ability to operate profitably.

The sale of Westland to HongKong Jingang Trade Holding Co., Limited, a subsidiary of Yili, requires shareholder approval, which, if obtained will result in the transaction occurring on 1 August. A shareholder vote is scheduled for July 4 and requires the approval from 75% or more of shareholders (in each interest class) who vote; and more than 50% of the votes of all shareholders entitled to vote.

The deal includes a share purchase at \$3.41 per share¹. The deal also guarantees that the milk produced by all existing suppliers will continue to be collected for the next 10 years. All existing Westland suppliers will be paid a milk price equivalent to or higher than Fonterra's **Farm Gate Milk Price**² for the next 10 seasons.

The sale of Westland will require High Court and overseas investment office (OIO) approvals; it is unlikely this would not be granted, **due to Yili's existing track record operating Oceania Dairy**. The sale is worth \$588 million, consisting of \$342.5 million for net debt and other liabilities plus the value of the shares. Farmers will receive a share price of \$3.41/share on their ~72 million shares, representing a cash injection into the hands of farmers in the vicinity of \$245 million.

¹ The nominal value of Westland shares currently range from 70c to \$1.50.

² In the event of the Farm Gate Milk Price not being available the milk price will be **benchmarked against another processor, or if this can't be agreed then against the weighted average milk price of the three largest South Island milk processors**.

Westland's 429 shareholders will receive on average \$572,000 from the sale of their shares. Even if a large share of these funds are used to repay debt, the multiplier effect of spending radiating through the local economy from the injection of funds from the sale of shares will positively impact the local economy to the tune of about \$280 million. For context, this is twice as much as has been allocated through the Provincial Growth Fund to West Coast projects.

The sale will provide a timely cash injection for farmers who have struggled to recover losses incurred during the downturn, **as Westland's milk price has been** well behind that paid by other New Zealand dairy companies in recent years. The funds will allow farmers to pay down debt and carry out necessary capital expenditure such as upgrading systems to meet tightening environmental standards.

The real value of the deal **isn't confined to the** share payment, but also the certainty that the terms of supply bring – particularly the guarantee that all existing suppliers will have their milk collected for the next 10 years, and will be paid a milk price comparable to (or better than) **Fonterra's**. This certainty will help bolster confidence in the sector and stabilise farm values. The quantity of farms changing hands in the West Coast region in the past three years has halved.

In the past three seasons Westland's milk price has trailed Fonterra's by an average of approximately 75c/kg MS. If Westland had been able to match Fonterra during the past three seasons, dairy farmers would have received an extra \$140 million over that time.

The deal doesn't provide for certainty of milk collections beyond 10 years, but it would certainly be in Yili's interest to collect as much milk as possible. Yili is a large purchaser of New Zealand dairy ingredients and the purchase of Westland provides certainty of supply for a portion of their requirements. But it is possible that farms located a long distance from processing facilities could incur additional transportation costs in the longer term, should it otherwise be uneconomic to collect the milk.

Supply chain traceability is very important to consumers in China and the ownership of Westland will certainly provide Yili with a way to prove the credibility of the ingredients used in some of their high-end products.

Yili is unlikely to want to invest directly in dairy farms in New Zealand, and would also be unlikely to receive OIO approval for such an investment. They **don't need to own farms in order to obtain milk supply**; they simply need to provide favourable terms to their suppliers, as has been the case with Oceania.

Dairy farming accounts for 11.7%³ of the West Coast economy, while the dairy processing sector accounts for a further 2.1%. Following the decrease in mining activity on the Coast the dairy sector now contributes more to the West Coast economy than any other sector. Jobs on dairy farms and employment in the dairy processing sector account for 9%⁴ of total employment in the region. The West Coast needs a strong dairying sector in order to prosper.

³ Infometrics 2018 data

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