ANZ Research

New Zealand Dairy Update

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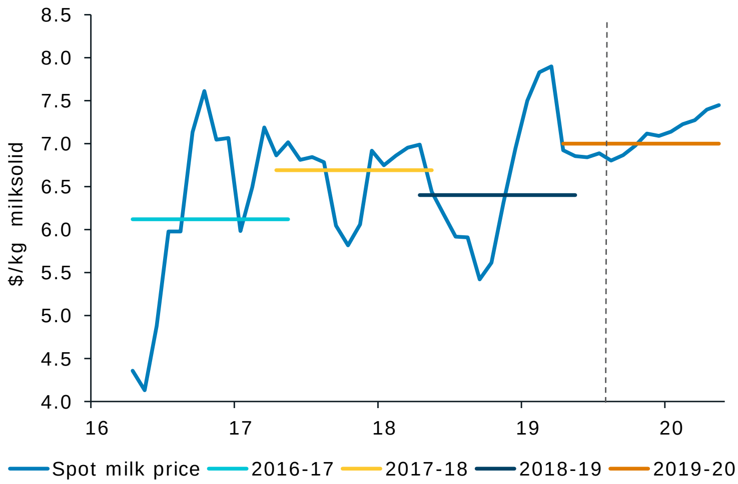
Downside risk to the milk price

Our milk price forecast for the 2019-20 season has been reduced by 10c to $7/kg milksolid. However, we question whether Fonterra will in fact be able to pay its farmers the full milk price that dairy prices and NZD developments would normally warrant this season. We estimate that potential further asset write downs could impair the payout by 20 to 45 cents.

Global dairy commodity markets are relatively stable at present. There is upside potential for prices as global milk supply growth continues to ease, but there are also clouds over the demand outlook in China. Whole milk powder is expected to continue to trade near the USD3,000/t level, which, combined with the weaker NZD indicates a farmgate milk price of $7/kg milksolid (MS) for the 2019/20 season, a small decrease from our earlier forecast of $7.10/kg.

Dairy commodity prices have traded in a relatively narrow band in recent months. Global economic uncertainty has kept a lid on buyers' appetite and recently the buying power of China, the world's largest importer of dairy products, has been eroded by the weaker yuan. However, global milk supply is stagnating in the main dairy-exporting regions as the cost of production increases. Tighter supply has the potential to lift prices later in the season.

Figure 1: Farmgate milk prices, historic and forecast



Source: Fonterra, ANZ Research

Can Fonterra afford to pay the usual milk price this season?

The Farmgate Milk Price is a set calculation based primarily on:

- prices attained for standard commodity products attained through sales either via Global Dairy Trade or alternative channels;
- foreign exchange rates; and
- the theoretical costs of operating a milk-processing plant.

While it is generally assumed that Fonterra will pay its suppliers the Farmgate Milk Price, it is not obliged to. There have been previous instances where Fonterra has elected to pay a lesser price. For example, in the 2013-14 season the theoretical Farmgate Milk Price was $8.93/kg MS, but Fonterra actually paid its suppliers only $8.40/kg MS that season. In that year Fonterra's earnings were impaired by processing capacity constraints that meant it was unable to manufacture the product mix assumed in the Farmgate Milk Price calculation.

At present, there is a heightened risk that Fonterra won't be able to afford to pay its suppliers at the level it normally would based on the usual calculations.

On 12 August Fonterra indicated its 2019 financial year performance would be impaired by some significant asset write downs. In total, Fonterra expects to write down $820-$860 million worth of assets in the 2019 financial year (table 1). As a result, it has announced there will be no dividend payable this season.

Table 1: Fonterra asset write downs to date

Asset	Country	Write down
Corporacion	Venezuela	$135 million
Dairy Partners Americas	Brazil	$200 million
China Farms	China	$200 million
NZ consumer business	NZ	$200 million
Australian ingredient business	Australia	$70 million
Other	Various	$15-$55 million

However, it appears Fonterra still has a number of assets on its books that may require further write downs. Beingmate is the most obvious one.

Beingmate

Fonterra owns an 18.8% stake in Beingmate, which equates to 192.4 million shares. Beingmate shares are currently priced at ¥5.50, about NZD1.21 at the current exchange rate, placing the total value of the investment at $233 million. Beingmate sits on Fonterra's books at $405 million, so would appear to be approximately $200 million overvalued.

Figure 2: Beingmate share price

Source: Reuters

On 7 August Fonterra confirmed it intends to exit its investment in Beingmate, as it no longer views it as a strategic investment. At that time it hadn't been able to secure a buyer. Fonterra can sell down its shareholding by offering up its shares of this listed entity, but that process would take some time due to the limitations on the quantity of shares that can be sold in a single on-market transaction. Shenzhen Stock Exchange rules limit sales in a share-holding to 1% every 90 days or 2% via a block trade. Trades of more than 5% can be made in an off-market transaction. Therefore unless Fonterra manages to find a buyer for its share in Beingmate it is going to be stuck with this investment for some time to come.

The profitability of Beingmate remains questionable. It did post a profit in 2018 but this was primarily due to asset sales.

China farms

Fonterra's China Farms is another investment that it can be argued is over-valued. At the end of the 2018 financial year the China Farms business had a book value of $748 million. The recent write-down brings this book value back to $548 million, but that is still nearly double the value of the livestock on those farms. The livestock have an estimated value of $280 million. That valuation therefore assumes the remaining assets are worth $268 million.

Aside from the livestock, other tangible farm assets include the milking sheds, barns to house cows, and infrastructure to store feed and effluent at each of the farm hubs. There will also be some less tangible value in the business, but it appears unlikely that the intangible items combined with the farm infrastructure would be worth the current book value. Therefore a further write-down of as much as $200 million is certainly possible.

Australia business

Fonterra's Australian business has two separate parts: the milk collection and processing part of the business and the sale of consumer goods. The consumer goods side of the business is reported to be performing admirably, but Fonterra's Australian milk collection business is under pressure.

Australia's total milk supply is shrinking as a result of ongoing drought and increasing costs of production – particularly the cost of water in certain regions. In the 2018-19 season Fonterra's Australian milk intakes fell by 20.3%. During the same time period Australia's total milk production fell 5.7%, so it is clear Fonterra is losing supply. And the supply it is retaining is coming at a cost, with strong procurement pressure from processors and milk brokers also taking a clip on some supply.

It is difficult to ascertain the exact value of Fonterra's Australian business, but given the contraction in supply to date and the further reduction in supply expected, the $70 million write-off appears to be on the light side. Fonterra's reputation with Australian dairy farmers took a dive following the Murray Goulburn fiasco. In the 2015-16 season Murray Goulburn provided a milk price forecast that was well above their actual ability to pay. This resulted in the company overpaying its farmers early in the season and then trying to recover these funds. The company was eventually sold to Saputo.

Fonterra had contracts with suppliers that were linked to the Murray Goulburn price, and so had also overpaid their suppliers. Fonterra's reputation took a bruising due to the way the company acted and communicated with its suppliers during that time, which has made it difficult for Fonterra to maintain its milk supply ever since.

Soprole - Chile

Soprole is another offshore milk-processing business that is suffering from falling milk intakes as Fonterra's share of the milk pool falls. Unlike Australia, Chile's total milk supply has been relatively stable in recent years. Fonterra owns virtually all of Soprole and this business has been consistently generating profits. However, these profits have been falling in recent years and some processing assets are reported to be 'tired', leaving questions about whether the book value of Soprole (which is over $900 million) is over-valued.

All up, total further asset write downs of $300 million to $700 million are estimated (table 2).

Table 2: Fonterra further potential asset write downs

Asset	Country	Potential write down
Beingmate	China	$200 million
China Farms	China	$100 - 200 million
Australian ingredient business	Australia	Up to $100 million
Soprole	Chile	Up to $200 million

This further level of profit write-downs would be difficult to absorb within the business unless profitability improves substantially. Therefore there is a risk that Fonterra may have to make a one-off reduction in its milk price payment in order to recover these potential losses. This $300-700m range equates to $0.20-0.45/kg MS.

Therefore, while our forecast for the calculated Farmgate Milk Price is $7/kg MS for the 2019-20 season, the actual price Fonterra may be able to pay its suppliers could be 20 to 45c less than this.

Note, earlier this week Fonterra said that it was holding its milk price forecast at its current rate of $6.25 to $7.25/kg MS. This milk price update was required under the DIRA legislation. Milk price futures for the 2019-20 season are currently priced at $6.81/kg MS.

Fonterra is due to release its Annual Report for the 2019 financial year next Thursday, which will provide more clarity of the exact levels of the write downs made to date. Fonterra is also expected to provide guidance on its future strategy and may address the book value of these assets.

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