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No use crying over spilt milk

Fonterra has confirmed a record loss of \$605m for the FY19 season, no dividend payment and a milk price of \$6.35/kg milksolid (MS).

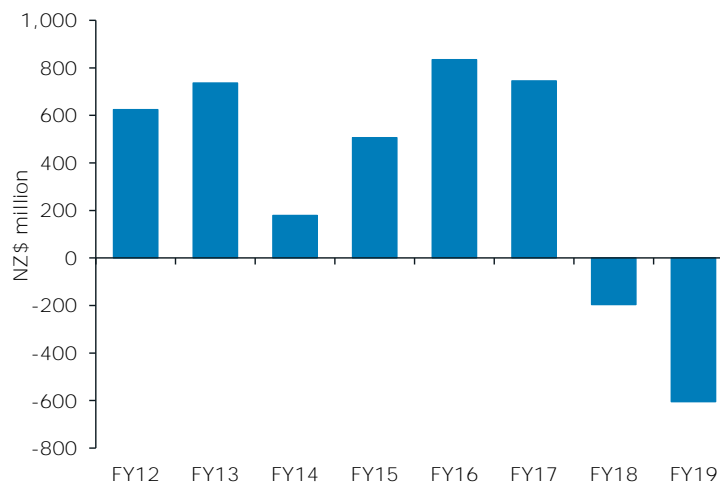
The company has outlined its strategy to concentrate on its core function of manufacturing New Zealand milk into ingredients and food service products. It also has a focus on being more financially and environmentally sustainable.

The previous guidance for FY20 of a milk price in the range of \$6.25 - \$7.25/kg MS remains unchanged. Earnings for FY20 are forecast to be 15-25c per share with a dividend guidance range reduced to 40-60% of earnings (previously 65-75%) indicating a dividend in the range of 6-15 cents.

Financial results

The net loss of \$605m for the 2019 financial year was in line with the guidance previously issued of a \$590-675m loss.

Figure 1. Fonterra profit (loss)



Source: Fonterra

Revisions to carrying values of assets (including those divested) and other one-off accounting adjustments were expected to reduce earnings by approximately \$820-\$860m. The actual adjustment was \$826m, at the smaller end of expectations.

Normalised operating expenditure decreased by 7% to \$2,311m in the latest financial year. This compared to \$2,496m in FY18.

As previously noted there will be no dividend paid for FY19.

Fonterra will be adopting a more conservative dividend payment ratio, with only half (40-60%) of earnings paid out as a dividend and the remainder retained. The previous policy was to pay 65-75% of earnings as a dividend.

Ingredients

The Ingredients section of the business is by far the largest portion of the company. This includes the ingredients business in New Zealand, global sales and marketing of New Zealand ingredients produced in New Zealand, milk supply and manufacturing in Australia, and ingredients in South America.

Normalised EBIT for this division was \$811m. This compares to \$879m in FY18. A year ago Fonterra forecast this division to achieve an EBIT of \$850-950m, so it has fallen short of this target. Revenue increased but so too did the cost of goods sold.

Consumer and Foodservice

The Consumer and Foodservice division achieved a normalised EBIT this season of \$450m. This compares unfavourably to an expectation of \$540-\$590m. Last year the Greater China area accounted for \$165m (31%) of the \$525m of normalised EBIT achieved by this division. Virtually all geographical segments of the consumer and foodservice division performed more poorly than the previous season. The Oceania section increased its normalised EBIT but this was more than offset by a \$204m earnings adjustment.

There was a sharp drop in returns from the Latin America segment as revenue fell while expenses held at previous levels. In addition, a \$143m impairment on the Brazil business and costs of \$112m associated with the disposal of the Venezuelan operation severely negatively impacted profits.

China Farms

China Farms delivered another operating loss. The loss this year was \$14m compared to FY18 where the normalised EBIT was -\$9m. However, when looked at on an end-to-end basis this division had a loss of \$30m, as a further \$20m loss was absorbed by the ingredients business. This is the first time Fonterra has acknowledged the full losses of this division.

Milk available for sale decreased due to issues with floods in Yutian and animal health problems.

Fonterra made it clear today they want to 'unlock the value' in China Farms.

They do see potential in the fresh milk market in China and expect prices will rise, but said the timing of this is uncertain. This division has consistently been unprofitable so exiting these farming assets is a logical choice for Fonterra. Whether they will be able to do this at current book values remains debatable.

Debt

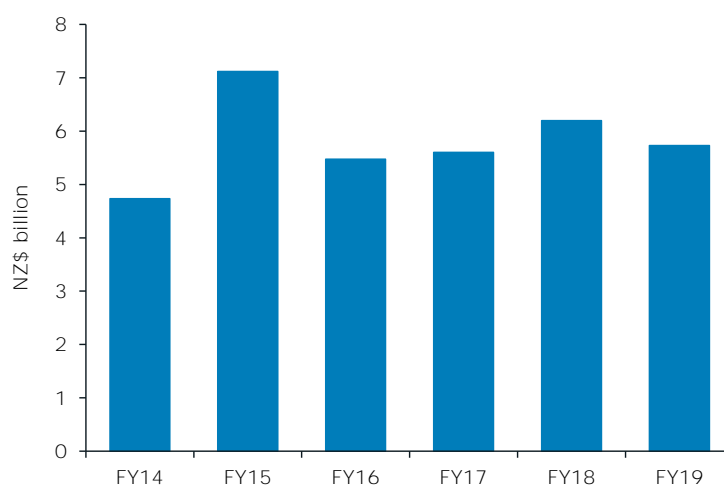
At the end of the previous financial year the economic net interest-bearing debt (net debt) was \$6.2bn. At that time, Fonterra had a debt/earnings ratio of 4.5x and a gearing ratio of 48.4%, and forecast reducing the gearing ratio to 40-45%. However, during the first half of FY19 debt gearing increased to 52.5%.

Fonterra had targeted reducing debt by \$800m by the end of FY19, but had previously conceded that it would fall short of this target. Net debt at the end of FY19 now stands at \$5.7bn. Debt gearing is at 48.2% and the debt/earnings ratio is at 4.3x.

However, **the figure doesn't take into account the sale of DFE Pharma announced yesterday, as this wasn't completed before the end of the financial year.** Fonterra advised that the sale of DFE Pharma for \$633m (inclusive of a \$96m vendor loan), means it has now reduced its total debt by \$1 billion.

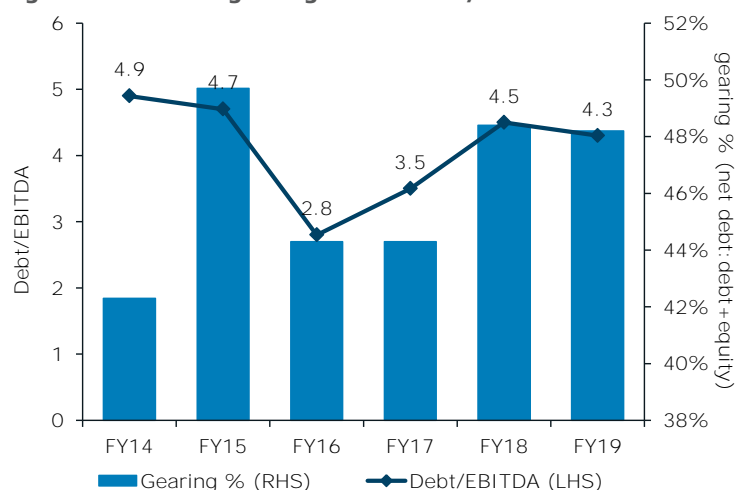
By the end of FY20 Fonterra are forecasting debt of \$4.4-4.6m due to the funds from the DFE Pharma sale and improvement in operating efficiency, including higher earnings, lower capex and further divestments, totalling \$500-700m.

Figure 2. Net interest-bearing debt



Source: Fonterra

Figure 3. Fonterra gearing % and debt/EBITDA ratio



Source: Fonterra

Asset sales

Fonterra has actively pursued asset sales this year, with the majority of the sales occurring in the second half of FY19. The process of asset sales revealed that a significant number of assets were overvalued on the books. Asset write downs announced earlier this year include:

Table 1. Fonterra asset write downs in FY19 (previously announced).

Asset	Country	Write down
Corporacion Inlaca	Venezuela	\$135 million
Dairy Partners Americas	Brazil	\$200 million
China Farms	China	\$200 million
NZ consumer business	NZ	\$200 million (net after \$100 million gain from TipTop sale)
Australian ingredient business	Australia	\$70 million

No further write downs were announced with the release of the full year financial accounts. The total value of write downs were confirmed to be \$826m. This included DPA Brazil, China Farms, Venezuela, Fonterra NZ, Australia Ingredients, and Beingmate.

Table 2. Fonterra asset sales previously announced:

Asset	Country	Ownership	Return (NZ\$)	Gain/loss on book value
Tip Top	NZ	100%	\$380m sold to Froneri	+\$100m
Corporacion Inlaca	Venezuela	60%	\$16m sold to Mirona	-\$126m
Goodminton AG (foodspring)	Germany		Mars brought large share of foodspring	+\$64m
Fast Forward (JV with First Milk)	UK	51%	Sold to Hoogwegt	
DFE Pharma (JV with Friesland Campina)	Netherlands	50%	\$633m sold to CVC Strategic Opportunities II	

Table 3. Other assets under review or on the market

Asset	Country	Ownership	Value NZ\$)
Beingmate	China	18.8%	Market value estimated to be \$223m, Book value \$204m.
China farms Yutian and Ying hubs	China	100%	Book value \$548m (livestock valued at \$280m).
Dairy Partners Americas	Brazil	51%	Strategic review underway

In March, Fonterra announced its intention to sell its 50% stake in **DFE Pharma**, a joint venture established in 2006 between Fonterra and Friesland Campina. It produces pharmaceutical excipients which are used as carriers in medicines including tablets and powders. Previous estimates put the market value of DFE Pharma at about \$200m. The sale of DFE Pharma to a fund called Strategic Opportunities II was confirmed yesterday. The selling price of \$633m includes a \$96m interest bearing loan from Fonterra for a 15 year term. The terms of the sale also include continuing to source lactose from Fonterra's Lactose plant based in Kapuni, Taranaki.

Fonterra continues to hold an 18.8% share in **Beingmate**, which equates to 192.4 million shares. Beingmate shares are currently priced at ¥5.24, about NZD1.16 at the current exchange rate, placing the total value of the investment at \$223m. This is above the current book value of Beingmate of \$204m. *Please note in an earlier Dairy Update we incorrectly advised that Beingmate had a book value of \$405m.*

Figure 4. Beingmate share price

Source: Reuters

Fonterra previously confirmed its intention to exit its investment in Beingmate, as it no longer views it as a strategic investment. 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 only be made in an off-market transaction.

A strategic review of Fonterra's **Dairy Partners America (DPA)** business in Brazil commenced earlier this year. This is a joint venture between Nestle and Fonterra, in which Fonterra has the majority shareholding. No further update was given for this business.

Aside from the assets mentioned above we previously advised concerns about the book value of a number of asset (see Table 4)

Table 4. Fonterra further potential asset write downs

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

At the end of the 2018 financial year the **China Farms** business had a book value of \$748m, which was subsequently written down to \$548m earlier this year. The potential for further write downs was based on the underlying livestock having an asset value of only \$280m and the ongoing losses the business continues to incur. Today Fonterra made it clear this division is on the market as it wants to realise the value it currently has tied up in it.

Fonterra's Australian ingredients business has struggled in recent years, due to the challenges farmers face of rising costs of production resulting in a reduction in milk supply. Fonterra has struggled to retain its share of this reducing pool of milk. In the 2018-19 season, **Fonterra's Australian milk intakes fell by 20.3%, while Australia's total milk production fell 5.7%.** While there are some geographical disparities that have resulted in milk volumes falling more in the regions Fonterra is exposed to, it is also losing milk to its competitors. Fonterra has made no further reference to this division in its announcement today.

Concerns have previously been raised about Fonterra's Soprole and Prolesure businesses in Chile. Milk intake has fallen in the business in recent years. This business has remained profitable but questions have previously been raised about whether this business is over-valued on the books. **No reference was made to the Chilean business in today's announcement**

Strategy

Fonterra today outlined its new strategy. This essentially focuses on deriving more value from New Zealand milk and continuing to divest non-core (offshore) assets. Fonterra plans to focus on ingredient categories: Paediatrics, Medical and Ageing, Sports and Active, and Core Dairy, which will include building on foodservice success in China and developing new markets, particularly in the Asia Pacific region.

They have also changed their operating model so they are better connected with customers. Fonterra has been criticised in the past for a lack of empathy and understanding of customer needs. The changes see the company divided up geographically by market rather than by product. The three new divisions will be Asia Pacific – led by Judith Swales; Africa, Middle East, Europe, North Asia, and the Americas – led by Kelvin Wickham; and Greater China – whose leader is yet to be appointed.

Changes at the board level

Fonterra is reassessing who should lead its board through its new strategy. The current chair, John Monaghan, is due to retire by rotation in 2020 but says he will be working with the board on the leadership succession plan. At this stage there has been no indication whether Monaghan will seek re-election, but it should not be assumed that he will retire next year. Given there is no assurance he would be re-elected if he choose to stand, this forward planning

by the board is imperative. Shareholders are likely to be looking much more closely at the skills, attributes and values board members can bring to the table as they look for a leadership team that can return Fonterra to a profitable operation.

Independent director Simon Israel has announced he will step down from the board at the next annual meeting in November when his current term expires. **Israel has served six years on the Fonterra board. Fonterra has said Mr Israel's decision is in support of planned succession and the need to phase the refresh of the Co-op's independent directors.**

Shareholder elected directors Donna Smit and Andy Macfarlane are standing for re-election this year, alongside newcomers Phillip Haas and Cathy Quinn. Smit joined the Board in late 2016 and Macfarlane the following year, so both joined well after the ill-fated decisions to invest in China farms and Beingmate were made.

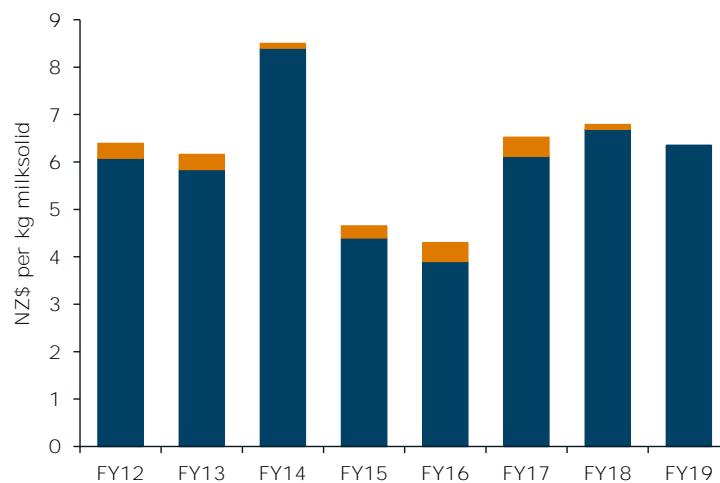
The Fonterra board has up to 11 members, with seven elected by shareholders and four appointed by the Board and approved by shareholders.

The season ahead

Fonterra has maintained its milk price forecast of \$6.25-\$7.25/kg MS for the 2019-20 season. We maintain our own forecast at \$7/kg MS, which is supported by the current strength in commodity prices and the recent easing of the NZD.

Earnings are forecast to be in the range of 15-25 cents per share. Under the new dividend policy where 40-60% of earnings are paid out this would equate to a dividend in the range of 6-15 cents.

Figure 5. Fonterra milk price and dividend



Source: Fonterra

However, retaining a portion of the milk price remains a distinct possibility and a risk to suppliers. While cutting back payments to its farmers suppliers is certainly not something Fonterra would wish to do, it has advised ratings agencies that this is something it can do (and has previously done) to manage financial risk. Rating agencies view this flexibility as positive, as it protects the interest of creditors.

Figure 6. Farmgate milk price, historic and forecast



Source: Fonterra, ANZ Research

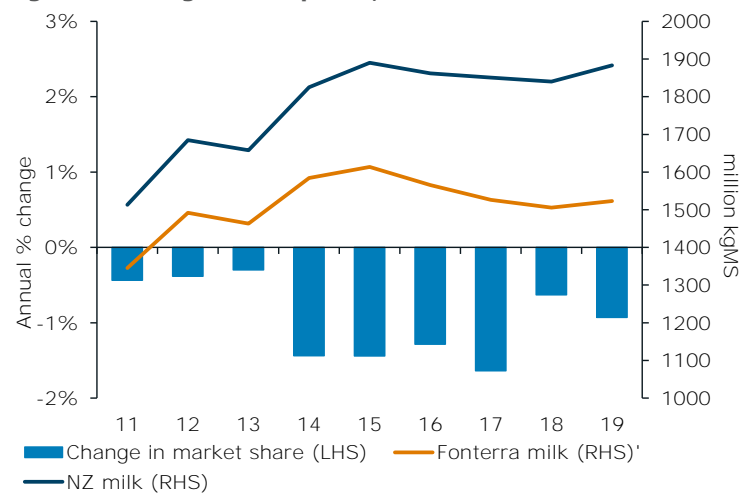
Competition between milk processors for New Zealand’s milk supply is expected to become more intense in coming years. The total supply of milk in New Zealand is expected to come under pressure as environmental and farm management regulations intensify and land moves to alternative uses.

Fonterra’s market share of New Zealand’s milk supply has steadily eroded as alternative processors expand their operations. If New Zealand’s total milk intakes fall then Fonterra’s share of this milk is likely to be eroded more quickly.

In the 2018-19 season Fonterra collected 1523m kg MS, which equates to approximately 81% of New Zealand’s total milk supply.

In the 2019-20 season Fonterra expects to collect 1,520 million kgMS, a very similar level to the previous season.

Figure 7. Farmgate milk prices, historic and forecast



Source: DCANZ, Fonterra, DairyNZ



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