

NEW ZEALAND ECONOMICS NEW ZEALAND DAIRY UPDATE

21 September 2016

CONTRIBUTORS

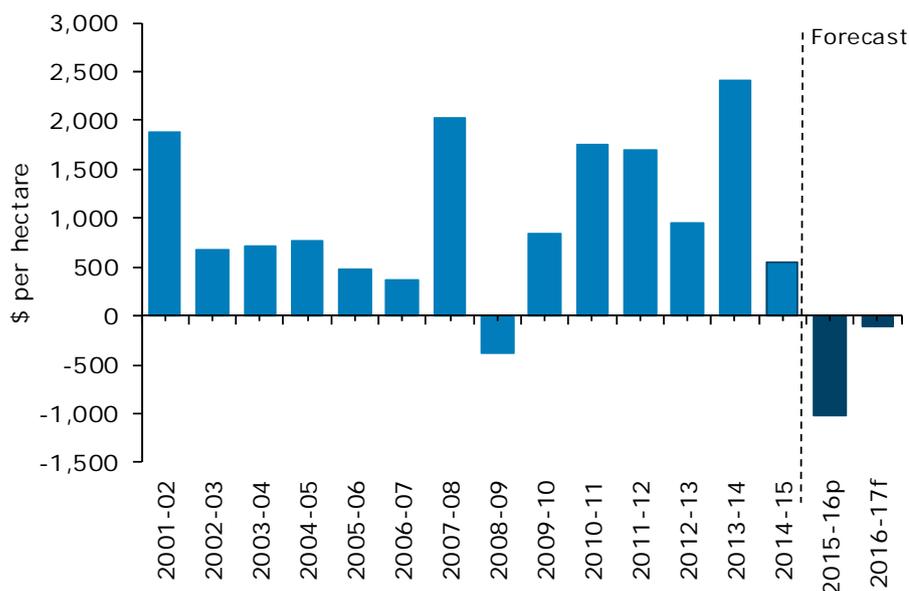
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SPRING GROWTH

Key thoughts on the dairy auction overnight and dairy processor updates:

- **Fonterra surprised the market this morning, upgrading its 2016/17 milk price forecast from \$4.75/kg MS to \$5.25/kg MS.** Other processors remain more cautious on the durability of the rally in international prices with current forecasts ranging from \$4.60-\$5.00/kg MS.
- **Today's update looks to be more aimed at increasing cashflow, with a significant step-up in the October advance rate (+\$0.50/kg MS), or \$0.30/kg MS for the financial year.**
- **For the average fully-shared farmer we have cashflow tracking at \$5.00/kg MS for 2016/17.** This will take many back above breakeven when combined with recent cost efficiencies and productivity improvements.
- **Dairy markets pushed slightly higher overnight (+1.7% GDT-TWI)** courtesy of stronger milkfat prices, but moves for milk powder prices disappointed (WMP -0.2% and SMP +3.0%).
- The momentum created in NZX dairy futures following the announcement of the Algerian tender results and lower 12-month GDT supply late last week is likely to take a breather for now.
- **Halted momentum in both markets, combined with the current level of the NZD/USD, will check spot milk price forecasts to around the mid-\$5/kg MS mark.**
- Fonterra's financial results tomorrow morning should confirm a \$3.90/kg MS milk price for 2015/16 (that is what has been indicated with today's advance rate update) and some underlying improvement for dividend earnings.

FIGURE 1: AVERAGE DAIRY FARM PROFITABILITY BEFORE TAX

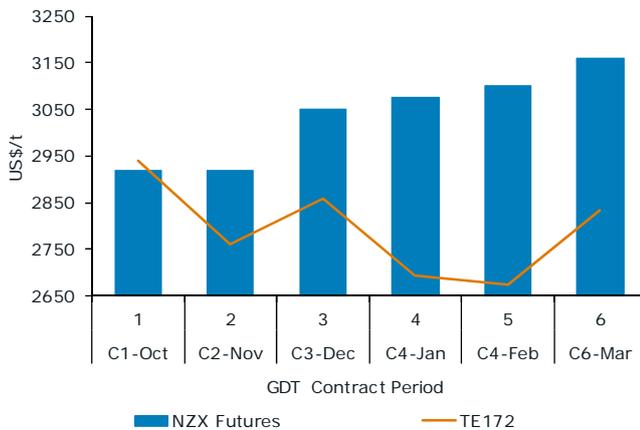


Source: ANZ, Dairy NZ

NEW ZEALAND DAIRY UPDATE

We believe the recent rally in dairy prices has more durability than those of the last 2 years. The newsflow remains supportive with signals of broad-based demand (not just Chinese buying), milk supply continuing to contract (on an annual basis) in key regions and tight inventory levels within New Zealand. Indeed the details of the recent Algerian tender were bullish (see this week's *Market Focus*) and yesterday FrieslandCampina announced an additional scheme (on top of the European Commissions) to pay farmers to reduce supply. The latter expects milk supply to be reduced by 150 million kilos of milk from now through to March 2017. The scheme is intended to accelerate a reduction in phosphate production in anticipation of new environmental regulation coming into force. Such developments, when coupled with milk supply softness in the UK, Germany and France (47% of annual European production) will see lower headline European supply through at least the back end of this year.

FIGURE 2. WHOLEMILK POWDER FUTURES VERSUS GLOBALDAIRYTRADE RESULT



Source: ANZ, GDT, NZX Dairy Futures

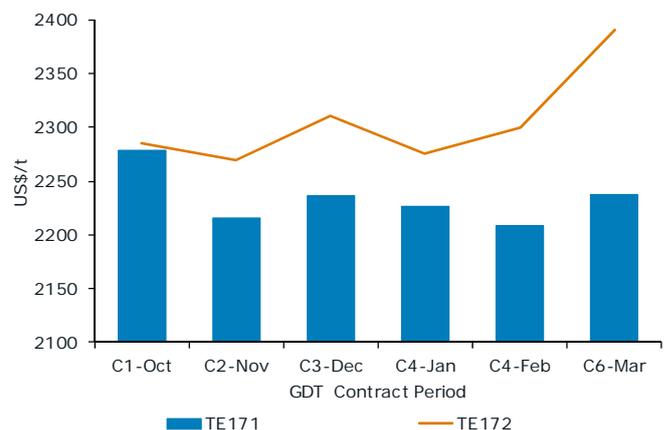
That said, last night's GDT auction showed signs the recent rally in milk powder prices could take a breather for a period. The driver of a flat outturn overnight looked to be softer Chinese demand after recent strong buying. The likes of contract 4 & 5 (January/February delivery) for WMP saw prices pull back suggesting enough buying has now taken place for the preferential free-trade window.

As this window closes the next series of auctions will be important in determining sentiment and the durability of the recent rally. With Chinese demand also been driven by hot-dry weather in North China (lowering fresh milk supply), recent buying activity looking more broad based than China alone, slowing milk supply in Europe and tight New Zealand inventories we expect the rally to have more durability than recent years. Last night's

auction and other sales by dairy processors (i.e. outside GDT) really confirms the US\$3,000/t mark for wholemilk powder will take some breaking in the near-term despite the recent run of positive newsflow. But if prices can continue to hold up in the US\$2,800-US\$3,000/t range this will push the farm-gate price higher still.

As an aside, we often get asked what the preferential free-trade window means. Essentially New Zealand's FTA allows for around 150,000 mt of milk powder to be imported into China at a tariff rate of 1.7%. The out of quota tariff rate is 10%. So Chinese buyers tend to try and forward purchase product as New Zealand's seasonal milk flow starts to increase and to try and land product in China in December/early January to qualify for the lower tariff rate. This is because the quota is reset on calendar year. It's been happening since the FTA was signed in 2008, but the tariff rate has moved lower and quota amount increased as time moves on making it a larger influence on prices. At the time the FTA was signed nobody thought New Zealand would send more than 150,000 mt of powder to China – how wrong everyone was! In recent years the quota has been filled within a couple of weeks of it being reset. It suits New Zealand's seasonal production curve too as without this demand New Zealand wouldn't be able to shift all its seasonal uplift in supply.

FIGURE 3. SKIM MILK POWDER



Source: ANZ, GDT

For the other products, SMP looks to still be playing catch-up to WMP more than anything.

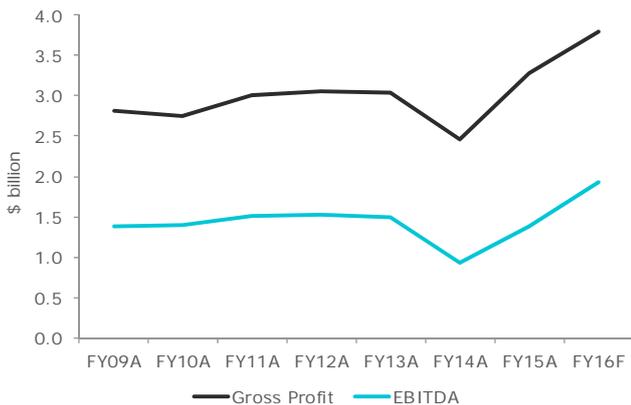
The flat forward curve at recent auctions suggests the market is anticipating being better supplied. One of the immediate challenges appears to be higher US supply with increasing momentum. With improved international prices US exporters will no doubt be looking to recoup lost market share from the last 18 months. There is also an overhang in Europe and more will be produced in early 2017 as seasonal milk supply increases.

NEW ZEALAND DAIRY UPDATE

The star of the show continues to be milkfat (AMF +4.6% and Butter +3.6%) with New Zealand the lowest priced producer. Robust demand within the major consuming countries (US and Europe) is limiting tradable supplies. Demand within these markets is being driven by a variety of trends such as consumers shifting back toward natural products and good foodservice demand.

Fonterra's financial results for 2015/16 are also due out tomorrow (Thursday) morning. We don't expect any change in the \$3.90/kg MS milk price and the dividend seems likely to come in toward the top end of the \$0.45-\$0.55/share range. Market expectations for the dividend are \$0.52/share. If achieved this could see a slightly higher than earlier flagged dividend of \$0.40/share (after retentions). Such a result when combined with the latest lift in the milk price to \$5.25/kg MS will help aid farmers current tight cashflow situation.

FIGURE 4. FONTERRA'S GROSS PROFIT & EBITDA

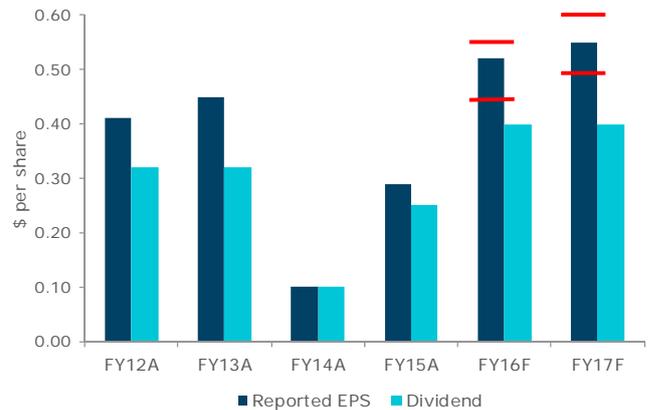


Source: ANZ, Fonterra, Bloomberg

The message from Fonterra's financial results should highlight some underlying improvement is starting to show though. This is being driven by higher margins (over and above the contribution from the drop in milk price); an improvement in Australian business operations; efficiency gains from recent restructuring activities/initiatives; a scaling back in capital expenditure; recent new partnerships starting to contribute additional revenue; and improved processing flexibility increasing the proportion of milk being turned into 'value-add' products.

The offset is likely to have been generally challenging economic conditions for dairy products within many major markets and fierce competition. The recent results from other international dairy manufacturers highlights these dynamics well.

FIGURE 5. FONTERRA'S HISTORICAL EARNINGS



Source: ANZ, Fonterra, Bloomberg.

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