ALL ROADS LEAD TO CHINA

- Profitability for dairy farmers still looks robust in 2017/18. A higher-than-assumed starting point for the NZD/USD creates some downside risks for the milk price, but there are offsets, and spring weather developments in New Zealand remain important too.
- Fonterra delivered solid 2016/17 financial results with exceptional foodservice sales growth into China and broader Asian markets.
- The perennial underperformer – the Australian business – delivered a positive result, but questions remain over Beingmate and to what extent its performance will lift in 2018/19.

Fonterra annual results confirmed a $6.12/kg MS milk price (previous $6.15/kg MS) and dividend of $0.40/share in 2016/17. Dividend earnings before retentions were $0.46/share – the bottom end of guidance.

Guidance for the 2017/18 season remained the same. All up an average fully-shared Fonterra supplier received cash-flow of $5.86/kg MS in 2016/17 and this is set to rise by $1/kg MS to $6.86/kg MS in 2017/18 (excluding Fonterra loan repayment requirements).

This saw profitability rise back close to long-run averages in 2016/17 at $990/ha.

A further lift in profitability is expected in 2017/18, but how much will depend on where the extra cash is spent/allocated. Depending on an individual farmer's position, some of the extra profit will go toward debt repayment to restore balance sheet strength. However, cyclical costs, such as dairy grazing and supplementary feed, are expected to increase working farm expenditure by $0.20-$0.40/kg MS. There is also a strong desire to reinvest after the lean period led to underinvestment. This is expected to increase working and capital expenditure in 2017/18.

Figure 1: Average dairy farm profitability before tax

![Figure 1: Average dairy farm profitability before tax](image-url)
MILK PRICE OBSERVATIONS

Fonterra’s FX position was stated as having “had foreign exchange contracts in place for approximately 71 per cent of the USD equivalent operating cash flow exposure expected to impact on the Farmgate Milk Price for the 2018 Season. If the balance was hedged based on a spot exchange rate of 0.7504 the average USD:NZD conversion rate would be 73 cents”. This implies an effective rate of 0.722 at the end of July, which is slightly higher than ours and what most other models had been applying for 2017/18. So all things equal, if the NZD/USD continues to hold-up, this implies $0.10-$0.15/kg MS of downside versus previous forecasts.

The offset to this is additional premiums for product sold outside the GDT channel and continued cost efficiencies. In 2016/17 the additional premiums for product sold outside the GDT channel was $0.06/kg MS. As yet there is no additional disclosure on the premium during a season, but in current market conditions this should be fairly steady. When the milk price moves above $7/kg MS, margins off-GDT are likely to be tighter, and the opposite is true when the milk price has a $4 handle in front of it. Cost efficiencies of $0.03/kg MS were also delivered, but given recent gains this could be difficult to replicate.

We expect international prices to hold firm. Namely the wholemilk powder market is in balance, which is seeing prices hold in a tight US$3,100 to US$3,200/t range. At the moment the wet underfoot pasture conditions in New Zealand are holding prices, but if the sunshine does emerge and supply increases we expect some downward pressure toward US$2,800-US$3,000/t to develop. Early season milk supply is also expected to be more durable if wet conditions persist as farmers use more supplementary feed. Supplementary feed demand has certainly lifted, with the price of barley, maize, wheat, palm kernel extract all pushing higher in recent months. This and farmer conversations suggest some pressure on early season milk supply, but equally farmers are willing to use more supplementary feed with better cash flow to support early season milk production.

Figure 2: Whole milk powder prices

Source: ANZ, GDT

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"This for product with like for like specifications that are sold on both the GDT platform and via other sale channels."
Elsewhere skim milk powder remains pinned down by high European Commission stocks and Northern Hemisphere competition. These dynamics are expected to persist with lifting milk supply in Europe and US, as well as high milkfat prices (particularly butter in Europe) producing more SMP too. **Milkfat prices continue to exceed expectations due to a tight butter supply-demand balance in Europe and robust demand from Asia** (for a range of milkfat products). However, forward-contract pricing for butter in Europe beyond the festive season is now moderating quickly and higher wholesale prices are filtering through to retail, reducing demand pressures. This suggests some price moderation into year-end.

![Figure 3: Milkfat price outperforming](image)

**Figure 3: Milkfat price outperforming**

![Figure 4: Butter price comparison between US, Europe and NZ](image)

**Figure 4: Butter price comparison between US, Europe and NZ**

All up, while we are holding our current milk price forecast ($6.75/kg MS), the higher starting position for the NZD/USD and WMP biased below US$3,000/t if New Zealand supply conditions improve, means a move back to $6.25 to $6.50/kg MS can’t be ruled out.
DIVIDEND AND WIDER FONTERRA OBSERVATIONS

Figure 5: Fonterra’s headline numbers

Source: ANZ, Fonterra

Fonterra’s headline results were solid, with gross profit stable despite an increase in the milk price (cost of goods sold), a negative relative shift in prices between reference and non-reference products and lower milk volumes. The steady result all involved shifting more milk into higher returning categories with impressive growth in foodservice sales, especially into Greater China. It also involved the turnaround of the Australian business to register a profit for the first time in many years. There looks to have been good cost control and solid sales growth in South America and the broader Asian region too. That said, there are still some problem areas in the form of getting Beingmate firing and issues with Chinese farms.

Figure 6: Fonterra dividend earnings

Source: ANZ, Fonterra.

Fonterra’s market share of milk collections in New Zealand dropped to 82% in 2016/17. Fonterra are forecasting milk volumes back to more normal levels in the 2017/18 season of 1,575m/kg MS (+3%). Interestingly, peak day milk is estimated at 85m litres (+6.3%) implying limited impact from current wet conditions in the major dairying regions.
The growth in the sales of foodservice products continues to exceed expectations, and is up 27% to 2.3b LME, or 10% of overall milk supply. There was strong growth for foodservice butter (milkfat story), UHT and mozzarella. Consumer product sales probably disappointed a touch only growing 3% to 3.2b LME, or 12% of overall milk supply. All up, an extra 576m LME were processed into consumer and foodservice products, which exceeded expectations of 400m. Overall the company is on track to nearly double sales in these categories by 2025 (aim 10b LME).

By region, China accounted for the lion’s share of the growth in foodservice and consumers products, up 46%, or 402m LME. There were also solid performances in Latin America despite challenging economic conditions in Brazil and Venezuela. Broader Asia saw 10% growth, with good performance from Sri Lanka and Vietnam.

The other higher returning category of Advanced Ingredients was split out for the first time, and accounted for 19% of overall supply. Advanced Ingredients are differentiated products that attract premium prices over base ingredients through superior product performance. Whey protein isolate and medical grade lactose are examples. A flatter seasonal milk curve, lower overall supply and inventories saw a 5% drop in GDT volumes and 11% decline in base ingredients. This obviously was an important element in helping rebalance ingredient markets in 2016/17.

The Australian business made a profit for the first time in many years. This involved a $200 million turn around through getting the right asset base, changing the capacity/reopening of Stanhope, changing the overall product mix and reducing costs. The fall from grace for Murray Goulburn also saw milk collection rise by 3%, while overall Australian milk production dropped 7%. The outlook highlighted Fonterra’s interest in some of Murray Goulburn assets and the fact that it is looking to grow its Australian milk pool share further.

There was strong cost control with overall expenses dropping 6% y/y. Cost reductions occurred over all the main expenses categories.

In China there are still some problem children. There was a $76 million write down for Beingmate made-up of $41 million in losses reflecting Fonterra’s 18.8% share of Beingmate’s performance and a $35 million impairment of the value of Fonterra’s investment. This was partially offset by the $42 million gain on sale for Beingmate’s 51% share of the Darnum site in Australia. The impairment loss of $35 million on its 18.8% stake reduces the investment valuation to $617 million.

Some will question whether this is enough, with its share price trading at RMB12.6/share over the last 12 months (and RMB10/share currently). This is a 30% discount from Fonterra’s buy-in valuation of RMB18/share. Fonterra’s explanation was market fundamentals for Beingmate are still strong and it expects some uplift/benefit from regulatory changes for the infant formula category that comes into effect on 1 January 2018. It is also viewed as a ‘strategic partnership where value extends beyond direct investment’. This implies a high degree of goodwill is being taken into account and a long-term view of the partnership.

The milk sourcing strategy for different markets and product categories was highlighted. This demonstrates the global sourcing strategy to deliver product 365 days of the year for the foodservice and consumer categories (all growth areas).
NEW ZEALAND DAIRY UPDATE

Figure 7: Milk sourcing strategy and product category growth

The milk sourcing strategy for China remains interesting split 77% NZ, 10% Australia, 7% Europe and 6% China. The Chinese farms progressed significantly toward full capacity in 2016/17 producing 335m LME (long-term aim 380-400m LME). Headline profit was positive for the first time too, with improving productivity and cost metrics. However, a big chunk of the turnaround appears to be the valuation applied to the Chinese farms milk with this being charged at ‘long-run’ instead of the actual market rate that was received. This was highlighted by Fonterra’s gross margin from ingredients including a $38 million loss representing the difference between the domestic Chinese milk price and the internal raw milk price paid to China farms. If domestic prices don’t improve and/or international price increase it implies an on-going internal loss.

OTHER POINTS OF NOTE

There is some concern about rising protectionism as it was noted “trading dairy nutrition is not easy. Tariffs on our products distort global dairy markets and mask pricing signals to international farmers. Ideally, we would have free trade into all of the markets in which we operate. Currently, 87 per cent of all New Zealand dairy exports are restricted by quotas or tariffs of more than 10 per cent. Lowering import tariffs will help countries to address food security concerns and lower food prices. They will also ensure New Zealand dairy products and dairy innovation remain price competitive and accessible to consumers in our key markets. Opening up market access and tackling non-tariff barriers must remain a priority for the New Zealand Government”.

There was a big focus on disruption and being an agile company with a number of new initiatives being implemented to drive innovation.

There is a big focus on sustainability and social responsibility initiatives across the number of business areas including: health & nutrition, trust in source (food safety), people (health, safety, wellbeing, diversity, learning), community development, environment (carbon footprint, water quality etc) and supply chain excellence.
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