

NEW ZEALAND ECONOMICS FONTERRA UPDATE

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STEADY AS SHE GOES

- **Dairy farmers continue to face financial pressure from a high NZD and low international prices.** Fonterra kept their milk price unchanged today at \$4.25/kg MS and provided a dividend forecast of \$0.50-\$0.60/share for 2016/17. While there is still plenty of water to flow under the bridge the current milk price is only around \$3.90/kg MS – so some decline in the NZD/USD and improvement in international prices is required to achieve this forecast. Open Country Dairy (New Zealand's second largest processor) acknowledged the same last week.
- **We continue to hold a mid to high-\$4/kg MS forecast for 2016/17, but international prices will need to break outside current ranges later this year to achieve it.** Supply-side dynamics remain key and we continue to see some encouraging signs. Southern Hemisphere supply is down across all the main exporters with more tightening to come over the next 12 months. European milk supply growth is slowing more sharply in some of the main producing regions (UK, Germany and France) and policy makers are beginning to more actively target supply to improve prices. The US continues to produce more, but most of the excess is being soaked up by domestic demand (i.e. exports are lower) driven by robust milk fat demand (i.e. butter and cheese demand). That said most buyers remain well stocked so any price improvement is likely to be slow going.
- **While we have higher expectations than Fonterra, such a number will merely dampen the intensity of cash-flow pressures facing the sector as opposed to remove them.** We don't see positive cash-flow for the sector returning until early 2018. That's still a way off.
- **The more important numbers continue to be cash flow related.** Small variations in forecast numbers at this time of the year don't tend to alter the revenue side of these too much. Today's update will see these largely unchanged on what farmers had budgeted earlier in the year. These were set fairly conservatively at the time around \$4.30/kg MS for a fully shared Fonterra farmer. Most farmers continue to show a cash loss of \$0.50-\$0.70/kg MS at these figures despite a number of cost reductions and farm management changes having been undertaken to lower cost structures. Many budgets are showing cost reductions of \$1.00-\$1.25/kg MS in operating costs. These are required to adjust to the current cyclical weakness in revenue, but also the structural aspect (i.e. lower for longer).
- **One of the positives today is dividend earnings guidance of \$0.50-\$0.60/share.** Since the change in capital structure in 2012 earnings per share have averaged \$0.31/share. Of this shareholders have received \$0.25/share and \$0.06/share has been retained. This has delivered an average cash yield of 4.1%. So today's announcement signals some underlying improvement. This will be welcomed as gross profit and normalised EBITDA haven't changed substantially since 2012, apart from the dip in 2014 due to the very high WMP price at the time, which is classified as a cost of goods for residual earnings. This has been of concern as the business has had an increase in core inputs such as milk supply, capital invested and there has been restructuring of various divisions/partnerships yet none of this has to-date driven gross profit, or EBITDA substantially higher.
- The improved underlying performance is being driven by higher margins (over and above the contribution from the drop in milk price), improvement in Australian operations (some of this due to Murray Goulburn troubles), efficiency gains from recent restructuring activities, a scaling back in capital expenditure and recent new partnerships starting to contribute. These factors are being somewhat offset by generally challenging economic conditions for dairy products within many major markets and fierce competition.

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