MARK-TO-MARKET

- Fonterra lifted its milk price forecast for 2017/18 (+0.15/kg MS), but marked down its dividend forecast (-$0.10/share) and investment in Beingmate (-$405 million to $244 million; initial investment circa $755 million).

- The lift in the 2017/18 milk price forecast to $6.55/kg MS with the season near 86% sold was the major bright spot. This will be the fourth-highest result on record and helps underpin farm-gate earnings despite a difficult production year for most farmers.

- A major talking point will be the $405 million impairment of Fonterra’s Beingmate investment. The total write-down from original investment is now $511 million, which equates to $0.32/share.

The upgrade in the 2017/18 milk price to $6.55/kg MS will be welcome. It’s a stronger result than our indicator, which is sitting around $6.40/kg MS with the season nearly 86% sold. The uplift implies stronger margins for product sold outside the GDT platform. It was indicated this has added $0.06/kg MS to the 2017/18 season so far, which implies a full season gain of $0.12/kg MS. Historically when the change to the milk price manual was announced a gain of around $0.04-0.05/kg MS was expected.

We maintain our 2018/19 opening milk price forecast of $6.00 to $6.25/kg MS. The recent downward pressure on NZD and milk powder prices holding at the top of recent ranges creates some upside risk, but we suspect international prices could be under a little bit of pressure into May on improved milk flow. The demand side of most dairy markets looks strong, meaning any downside should be fairly limited.

At the farm gate cash flow now looks reasonably solid heading into early 2019. The upgrade to the 2017/18 milk price lifts deferred payments (July-October 2018), which flows into 2018/19 budgets. For the average Fonterra supplier who is 100% share backed we have cash flow of $6.72/kg MS in 2017/18. Assuming an opening milk price in May around the low $6.0/kg MS mark, then cash flow for 2018/19 will be at a similar level.

However, it has been a more difficult production season for most farmers, that has come at a higher cost due to the use of more supplementary feed to keep cows milking. Autumn production conditions now look favourable, which will extend days in milk for most farmers, boosting end-of-season production. Still, overall NZ production is expected to finish down around 1.5% y/y, with large variations by region depending on the bite taken out of production during the hot and humid December/January period. This, and farmer concern on the regulatory front, have impacted confidence despite a solid earnings backdrop.

All up we have average farmer profitability tracking at $1,220/ha in 2017/18, but this reduces back toward the long-run average of $920/ha in 2018/19 (on a lower milk price outlook). If achieved this would be an unusual pattern; the historical experience has been two good years followed by a more difficult one. For most farmers a consistent milk price in the low-to-mid $6/kg MS range represents a solid profit margin.
A major talking point will be the downgrade to the dividend range to $0.25-0.35/share (-$0.10/share) and the Beingmate impairment. It’s yet to be decided how the Beingmate impairment and Danone payment will be treated for final dividend purposes. Historically, one-offs have been added to the balance sheet, or have seen reduced retained earnings. The Board will have to weigh up the impact on balance sheet strength (likely to push above the 45% target, but not as high as 2014/15); the balance between retained earnings and dividend returns to shareholders; and ability to pursue new investment opportunities/partnerships (linked to retain earnings and balance sheet strength).

In total the Danone settlement and Beingmate impairment are a $565 million cost, which equates to a loss of $0.35/share in 2017/18. The Danone cost represents $0.10/share and Beingmate $0.25/share. However, the impairment on Beingmate is more significant when viewed against the initial investment around $755 million and the current valuation of $244 million. If the $42 million partial sale of the Darnum site in Australia to Beingmate (51% share) is ignored (we are not sure of the exact accounting treatment that was applied to the sale), these figures imply an overall loss of $511 million, or $0.32/share. The Beingmate investment is now being valued close to its current share price. A turnaround will be important for the overall growth in New Zealand infant formula sales to China.

Figure 1: Average dairy farm profitability before tax

Source: ANZ, Dairy NZ
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