

NEW ZEALAND ECONOMICS NEW ZEALAND DAIRY UPDATE

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CONTRIBUTORS

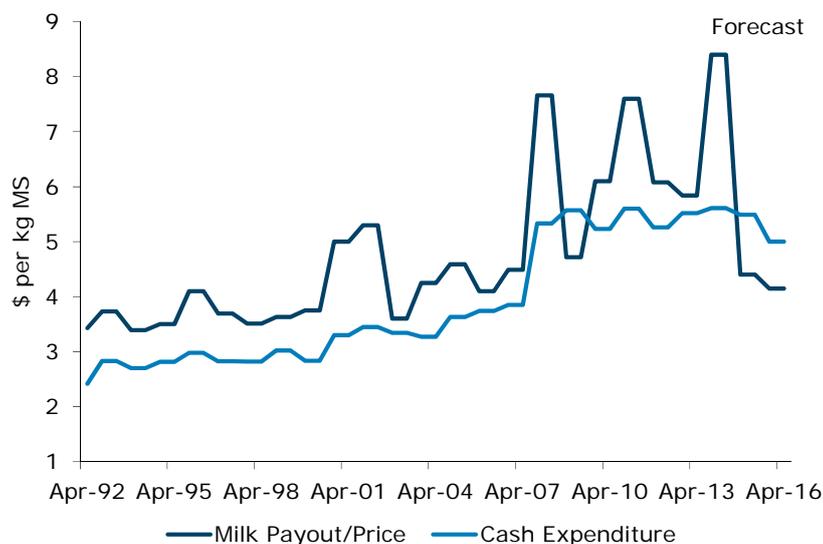
Con Williams
Rural Economist
Telephone: +64 4 802 2361
E-mail: Con.Williams@anz.com

WHEYED DOWN

KEY POINTS

- Fonterra updated its milk price forecast to \$4.15/kg MS. This is a reduction of \$0.45/kg MS from the previous forecast of \$4.60/kg MS.** The forecast dividend range (paid out) was left unchanged at \$0.35-\$0.40/share. However, dividend upside was flagged with the statements that it was “on track to generate improved dividend returns” and “we will look at the best way to help our farmers’ cash flows, underpinned by the expected improvement in dividend returns”. We await the half year results for 2015/16 for further clarity.
- The forecast reduction is in-line with expectations and the earlier announced forecast reductions from competitors Open Country Dairy and Westland. All these forecasts imply that it is going to remain tough for international dairy prices over the first half of 2016.** Current market dynamic’s look very tough, especially milk supply which remains high offshore and is likely to improve in New Zealand. This combined with lower seasonal demand from China means it could be a tough couple of months for GDT auction prices.
- Year-to-date New Zealand milk supply is tracking 2.6% behind the same period last year.** This is impressive given the headwinds to production: the slow start to the season, a near 4% decline in the number of cows in-milk and challenging financial conditions for the sector. It implies a very strong productivity performance (i.e. high per head performance); especially given the cost cutting and revamp of production systems that is taking place. Improvements which are helping to lower industry break-evens.

DAIRY MILK PRICE VS. CASH EXPENDITURE (INCLUDING INTEREST & RENT)



Source: ANZ, Fonterra, Dairy NZ

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- Industry forecasts remain for a 6% y/y decline in milk supply for this season. This implies an 11% y/y drop in milk supply over the last five months of the season. This seems less likely** with the improvement in pasture/forage conditions, high palm kernel imports, low domestic grain prices and year-to-date performance. **At this stage it seems more likely there will be a 4% y/y decline for the entire season, which implies a 6% y/y drop in milk supply over the last five months of the year.** The last five months of the season are always more variable given the management choices that can be undertaken. So while we still expect lower growth, year-to-date results highlight the resilience of New Zealand dairy farmers and production model under the challenging conditions.
- Cashflow is the life blood of any business and today's announcement will continue to apply pressure to many dairy businesses balance sheets well into 2016/17.** Indeed today's announcement is expected to see deferred payments from the milk price in 2016/17 drop to just \$0.12/kg MS. This means cashflow is expected to remain under pressure until at least early 2017.
- At this early stage we currently hold a milk price forecast of \$5.50-\$5.75/kg MS for 2016/17.** This assumes a lower currency (in the mid-to-low NZD/USD 0.60's) and a modest improvement in international prices (i.e. WMP to mid-\$2,000/t). Under this situation cash flow reaches around the \$5/kg MS mark in 2016/17. **Improved cost efficiencies has lowered the industry's breakeven pay-out to the low-to-mid \$5.00/kg MS, but this still implies a second year of cash losses for many businesses and continued economic strain in the sector into 2018.**
- The RBNZ released an update of the assessment of the dairy sectors vulnerabilities in December. It includes three scenarios for cashflow and land values. Current cashflow forecasts are shaping up similar to the moderate downturn scenario, but land values are still holding up for now. Under this scenario it suggested non-performing loans would increase toward the 15% mark over the next 18 months. So expect financial stress to remain high and dairy farmers to keep the cheque book locked away.

CASHFLOW SCENARIOS FOR FULLY SHARED FONTERRA FARMER

	Milk price scenario					
			Milk price of \$4.15	Milk price of \$5.00	Milk price of \$5.50	Milk price of \$5.75
	2013/14	2014/15	2015/16p	2016/17f	2016/17f	2016/17f
Deferred payment	\$0.69	\$1.50	\$0.07	\$0.12	\$0.12	\$0.12
Milk price (inc. Capacity adjustment)	\$7.59	\$5.60	\$3.79	\$4.00	\$4.40	\$4.60
Dividend	\$0.21	\$0.15	\$0.30	\$0.38	\$0.38	\$0.38
Fully shared	\$7.80	\$5.75	\$4.16	\$4.50	\$4.90	\$5.10

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