

NEW ZEALAND DAIRY UPDATE

17 May 2017

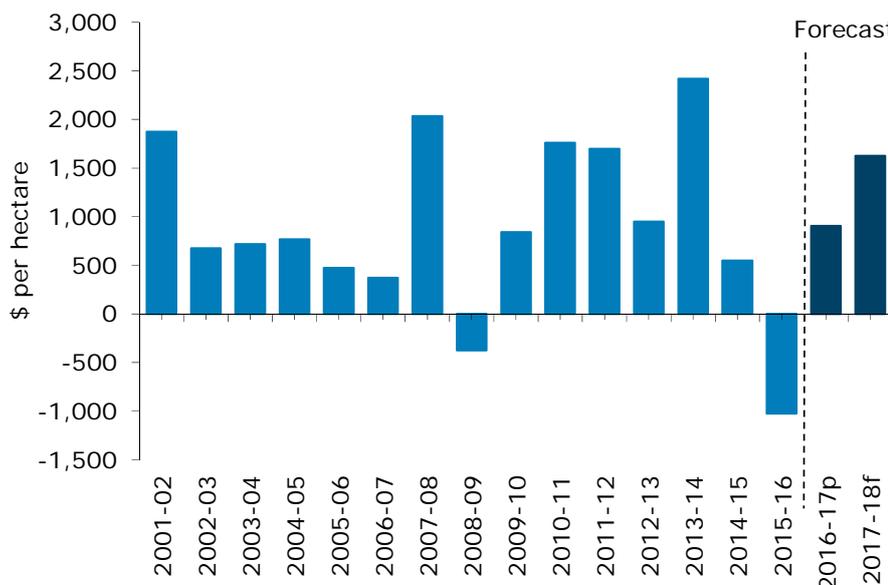
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CREAM ON TOP

- Dairy prices continue to show strength, especially for milkfat, which has pushed to all-time highs on the GlobalDairyTrade platform.
- Combined with a capped (in effect weaker) NZD/USD, we have lifted our milk price forecast to \$6.75/kg MS for 2017/18. The year-end milk price for 2016/17 would appear to have \$0.15 to \$0.20/kg MS upside also (i.e. \$6.15 to \$6.20/kg MS). It portends of an improved cash-flow outlook, although any increase will trigger Fonterra loan repayments from the deferred component to be repaid in 2017/18 providing some offset.
- Cashflow for the average fully-shared Fonterra supplier looks to be \$5.75/kg MS in 2016/17 and this is set to improve into the mid-\$6.00/kg MS in 2017/18 (using above forecasts, a similar dividend and excluding loan repayments). With breakeven for the sector in the low-\$5s, the sector is moving back into the black and spare cash should start to emerge later this year.
- A big focus will be debt repayment from the poor 2015/16 season. The sector accumulated circa \$1.50/kg MS of debt during this period and this will need to be reduced to improve financial resilience back to where it was prior to the downturn, particular with interest rates moving up. However, there will be some natural uplift in spending related to cyclical costs that swing with the milk price (supplementary feed, grazing, repairs & maintenance etc) and capital expenditure that was trimmed to unsustainably low levels during 2014/15 and 2015/16.

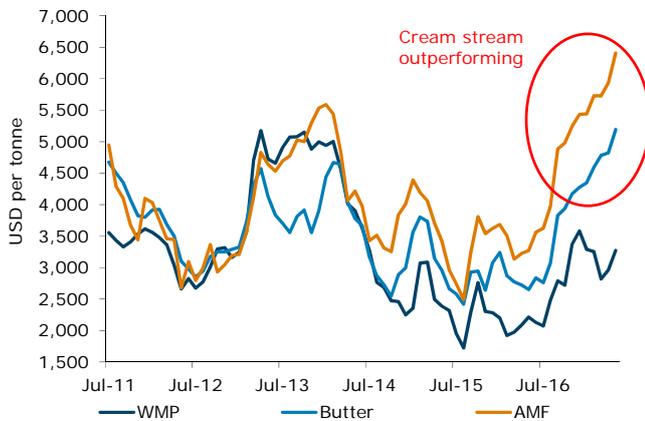
FIGURE 1: AVERAGE DAIRY FARM PROFITABILITY (INCLUDING FINANCE COSTS)



Source: ANZ, Dairy NZ

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FIGURE 2: CREAM STREAM OUTPERFORMING

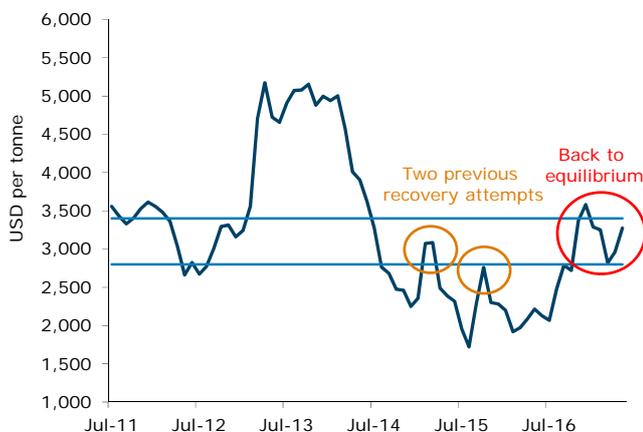


Source: ANZ, GlobalDairyTrade

- While we expect global milk supply to lift as 2017 progresses, robust demand from China, Middle East (restocking) and steady demand elsewhere is expected to be able to absorb increases.** Milk supply is biased higher in Australia, New Zealand, Europe and US drive by farm-gate returns above long-term averages, low supplementary feed prices and the likelihood of better seasonal conditions (i.e. unlikely to see a repeat of the poor spring production seen in New Zealand last year). At present European supply is being held back by more challenging weather conditions in key countries such as France, Germany and Poland. In the Netherlands, there remains concern about the impact that tightening environmental regulations will have on supply. Nevertheless, other supply indicators remain positive.

- With the market more in balance, we expect whole milk powder to continue to trade in a US\$2,800 to US\$3,400/t range, with a midpoint around US\$3,100/t.** This is our long-run view and a band prices have been trading in since September last year when supply adjustments led to the market rebalancing. **We expect skim milk powder to remain capped** with ample Northern Hemisphere supply to weigh on the market for some time to come. **Milkfat price direction remains harder to gauge and upside would seem limited**, but some buyers appear to be short of product to mix with skim milk stock where shelf-life is ticking (i.e. they need to use it). Additionally as we have highlighted before, end-demand remains robust with the expansion of foodservice demand in emerging markets and changing consumption patterns in mature markets. So until new season supply from New Zealand lifts or Europe diverts product from domestic markets, prices are expected to remain robust.
- Dairy markets will remain volatile.** While reduced supply lifted prices in late-2016, supply indicators are pointing higher. The commodity complex globally still looks vulnerable to a turn in the deflation trade (which we have arguably seen in some pockets), though each commodity will be influenced by its own supply/demand characteristics.

FIGURE 3: WHOLEMILK POWDER BACK IN THE BAND



Source: ANZ, GlobalDairyTrade

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