ANZ RESEARCH

NEW ZEALAND ECONOMICS
NEW ZEALAND DAIRY UPDATE

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POST PARTY HANGOVER LINGERING

KEY POINTS

- **Fonterra kept the 2014/15 milk price forecast at $4.70/kg MS, but lowered its dividend range to $0.20-0.30 per share.** This means a fully share backed farmer will receive $4.90-$5.00/kg MS. After finance costs, this will be below break-even for many, especially those worst affected by the dry conditions.
- **There was clear evidence in the business performance (dividend) of a hangover effect from the 2013/14 season and volatility in different dairy markets affecting margins.** This is highlighted by higher priced inventory from 2013/14 weighing on margins in the first quarter, as well as higher farm-gate milk prices in other countries (Australia/Chile) also affecting some consumer and foodservice businesses earnings. This was not unique to Fonterra's performance during this period with many other rivalries also struggling.
- **There was tougher talk on improving performance compared with recent communications.** This is likely to reflect increasing pressure from farmers. There is a clear strategy in place, but the execution and change to culture/business practices appears challenging for the Co-operative. This, overlaid with a challenging operating environment, and many things that are outside Fonterra's sphere of influence, appear to be a drag on earnings at present. **How quickly the execution side of the strategy can be addressed through the "business transformation programme" will be key for earnings potential in 2015/16 and getting farmers back on-board for the ride.**
- The milk price assessment for 2014/15 seems fair and with nearly 90% of the season sold this shouldn't change too much. However, dairy farmers are counting every cent at present and **if international prices continued to weaken into the end of the season then there could be some slight downside** ($0.10-$0.15/kg MS).
- **Prospects for 2015/16 and the opening advance to be announced at the end of May remain key.** Under today's forecast, cash flow is set to tighten significantly through to the end of 2015, but by how much remains unknown at this stage. **With 2014/15 largely set, the key for how much cash flows tighten is the opening advance for 2015/16**.
- **At this stage we hold a milk price forecast of $5.75/kg MS for 2015/16. The last GDT auction is consistent with something a touch below this (depending on currency assumptions), but what the price action has highlighted is that sentiment is weak at present.** If a short-term weakening trend into the middle of the year does occur this will put pressure on the opening advance for 2015/16 and even more pressure on farmers' cash-flow over coming months.
- **The sector can manage one tough year, but two in a row would be a real test.** Tighter cash-flow will necessitate cuts in not just capital and discretionary expenditure, but core operating expenditure to avoid a debt blowout. This will create some gestation issues across the economy.

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Dairy incomes continue to dominate as a key downside risk for the New Zealand economy. Dairy prices need to continue to improve for profitability to be restored across the industry and the heavy build-up in leverage to not become problematic.

We project milk powder prices to trade around the low US$3,000 per tonne mark by the middle of the year and then US$3,300-US$3,500 per tonne by early 2016. This means a farm-gate milk price of $4.60-$4.70/kg MS is likely in 2014/15, with nearly 90% of the seasons product sold. We're also currently expecting an opening price in May for 2015/16 around the $5.75/kg MS mark.

TABLE 1. MILK PRICE SCENARIOS FOR 2015/16

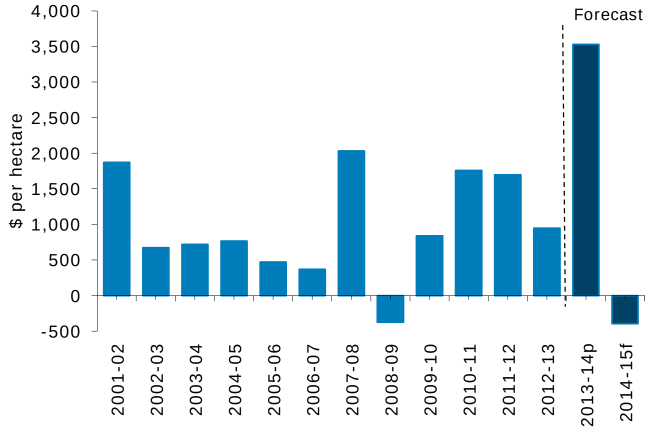
	Fonterra Milk Price Component Scenarios (NZ$ per kg MS)					
		NZD/USD				
Basket of NZ Dairy Products	USD	0.70	0.725	0.75	0.775	0.80
	2500	5.14	4.96	4.79	4.64	4.49
	2700	5.55	5.35	5.18	5.01	4.85
	2900	5.96	5.75	5.56	5.38	5.21
	3000	6.16	5.95	5.75	5.57	5.39
	3100	6.37	6.15	5.94	5.75	5.57
	3300	6.78	6.54	6.33	6.12	5.93
	3500	7.19	6.94	6.71	6.49	6.29

The last GDT auction is consistent with a 2015/16 milk price a touch below this (depending on currency assumptions), but what the price action has highlighted is that sentiment is weak at present. China remains absence, Russia is moving well down the major importer ranks, some oil dependant countries' economies look in trouble, Europe is looking to pounce on several key New Zealand markets and there has been substantial downward pressure on cost structures (lower grain and energy prices). These five dynamics, along with Southern Hemisphere seasonal conditions remain key for the direction of dairy prices now and well into 2015/16. If a short-term weakening trend into the middle of the year does occur this will put pressure on the opening advance for 2015/16 and even more pressure on farmer's cash-flow over coming months.

More upward momentum for prices is likely to take hold in the second half of 2015 as inventory are run down and lower farm-gate prices bite across the main exporting regions slowing supply and helping further rebalance the market. As lower dairy product prices feed through to retail this should also help stimulate demand in many emerging markets.

While there are lots of moving pieces at present, which could change this view, cash-flow looks tight through the second half of the year under a number of scenarios (See December Agri Focus for a more detailed explanation http://www.anz.co.nz/rural/rural-news-insights/agri-focus/). The tight cash flow through this period will necessitate cuts in not just capital and discretionary expenditure, but also some core operating expenditure categories to break even and avoid a debt blowout.

FIGURE 1. AVERAGE DAIRY FARM PROFTIABILITY BEFORE TAX



Source: ANZ, Dairy NZ

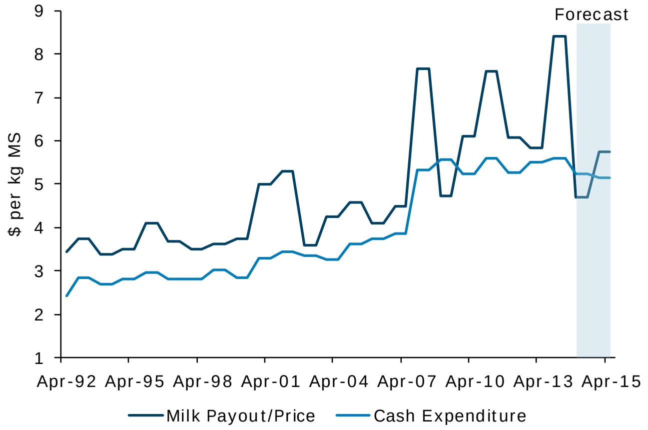
While cash flow looks tight there are some key mitigating factors:

- **Cost structures were far better controlled** post the record breaking 2013/14 season compared with previous surges.
- **Leverage is heavily concentrated** with around half the debt held by 20% of farmers. Many of these are larger/corporate operations that tend to have more balance sheet flexibility and often better financial performance from investment in key areas. Lower interest rates have reduced interest costs despite an increase in debt levels. On the typical farm this has seen interest servicing costs decline by nearly $0.50/kg MS since the GFC.
- **Productivity growth has been impressive** and has run 3.5% above trend (as measured by MS/cow) over the last three years.
- **There has been a huge amount of investment back into dairy operations over the last five years.** According to Dairy NZ the average farm undertook $850,000 of capital expenditure, with $720,000 of this funded from retained earnings. **This creates more "flex" for cost structures during leaner times, has created greater efficiencies, and adds to productive capacity.**

There was clear evidence in Fonterra's business performance (dividend) of a hangover effect from the 2013/14 season and volatility in different dairy markets affecting margins of different businesses. This is highlighted by higher priced inventory from 2013/14 weighing on margins in the first quarter, as well as higher farm-gate milk prices in other countries (Australia/Chile) also affecting some consumer and foodservice businesses earnings. This was not unique to Fonterra's performance during this period with many other rivalries also struggling.

The press release also seemed to be talking tougher on improving performance compared with recent communications over the last six months. This is likely to reflect increasing pressure from farmers. There is a clear strategy in place, but the execution and change to culture/business practices appears challenging for the Co-operative. This, overlaid with a challenging operating environment and many things that are outside Fonterra's sphere of influence appears to be a drag on earnings at present. How quickly the execution side of the strategy can be addressed through the "business transformation programme" will be key for earnings potential in 2015/16 and getting farmers back on-board for the ride.

FIGURE 2. DAIRY MILK PRICE VS. CASH EXPENDITURE (INCLUDING INTEREST & RENT)



Source: ANZ, Fonterra, Dairy NZ

The sector can manage one tough year, but two in a row would be a real test. Tighter cash-flow will necessitate cuts in not just capital and discretionary expenditure, but core operating expenditure to avoid a debt blowout. This will create some gestation issues across the economy.

The economy has pep from other sources to absorb low pay-out challenges. The outlook for the economy is still respectable (supported by accommodative financial conditions, record net immigration and elevated confidence). However, we are mindful of the frictions and tensions present from the global backdrop, which risks impacting other commodities (and is in some quarters) and demand, with the situation being complicated by a NZD that remains elevated and near post-float highs against some major trading partners. **Our base case remains an extended period of stable OCR settings, but the RBNZ will continue to closely follow the global scene and commodity price outlook.**

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