ANZ RESEARCH

NEW ZEALAND ECONOMICS
FONTERRA MILK PRICE UPDATE

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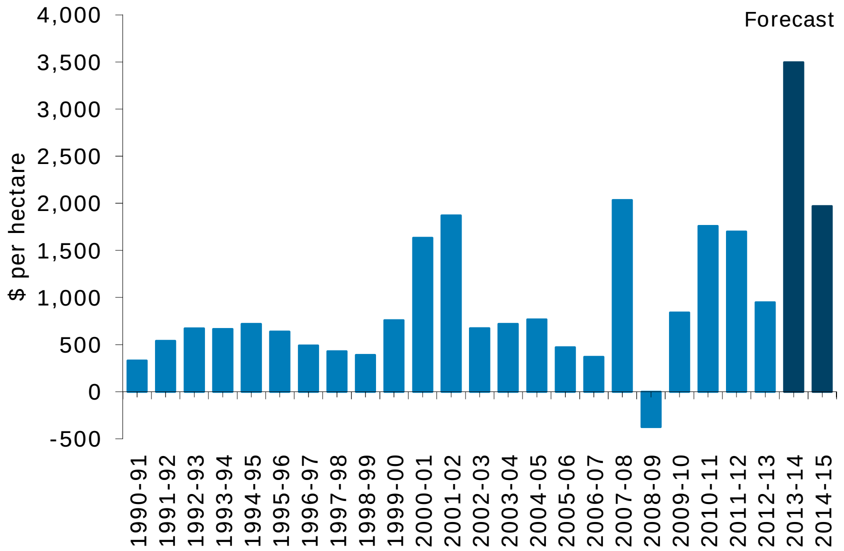
STILL MILKING IT

KEY POINTS

- Fonterra lowered its **2013/14** milk price forecast to **$8.40/kg milksolids (ms)** (-3%, or $0.25/kg ms) and has started **next season with $7/kg ms** (historically high and well in excess of cash expenditure for a typical farm).
- **On the face of it the decline in the milk price is a drag on the economy** over the coming 18 months to the tune of $2.6 billion, or 1.1% of GDP, but that **dynamic is exaggerated.**
- The **coming year's milk price forecast would be the 4th highest on record** if achieved and the dividend still needs to be added (which should perform better than in 2013/14).
- From a **profitability and cashflow** point of view farmers will still be in a **very good position** over the coming 12 months. In fact cashflow is likely to be very similar to the past 12 months.
- A **stellar productivity story** is not hitting the headlines. It is lifting output and also helping keen the cost line contained (which has typically explode in a good payout year).
- Total **milksolids production is up by nearly 10%** y/y to 1.825bn kg ms for 2013/14. This will eclipse the previous record set in 2011/12 by 8%. This reinforces some of the positive developments in farm systems, skill sets and behaviours in recent times.
- While the dairy payout grabs all the headlines, we note **Fonterra is still pushing forward in a number of areas.** Such small **subtleties** shouldn't be overlooked as they **support the medium-term picture.**

FIGURE 1. AVERAGE DAIRY FARM PROFITABILITY BEFORE TAX



Source: ANZ, Dairy NZ

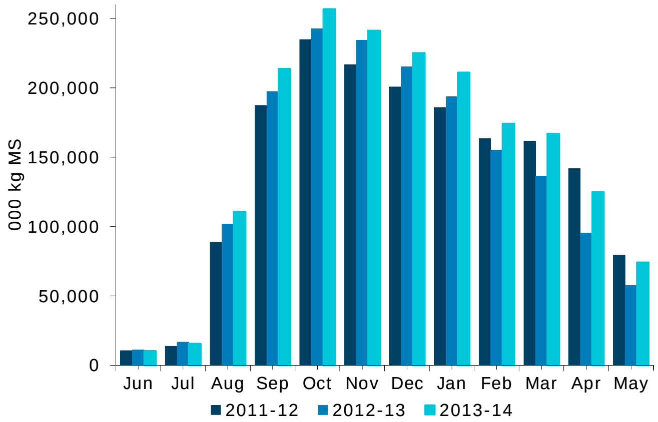
FONTERRA MILK PRICE UPDATE

2013/14 FONTERRA MILK PRICE UPDATE

Fonterra lowered its 2013/14 milk price forecast to $8.40/kg milksolids (ms) (-3%). This represents a $0.25/kg ms reduction from the February forecast of $8.65/kg ms. The dividend outlook of $0.10 per share remained unchanged. This means a 100% share-backed farmer will receive $8.50/kg ms, which will beat the previous record of $7.90/kg ms set in the 2010/11 season. **While the reduction takes $395 million out of incomes, (0.2% of GDP) it just takes a little bit of cream off the top of a stellar season.**

Average farm profitability is still expected to be nearly $3,500/ha, courtesy of not only the record payout, but also constrained expenditure and record production in many regions – which makes for a potent mix. **This level of profitability is nearly three times the seven year average.**

FIGURE 2. NZ MILK PRODUCTION



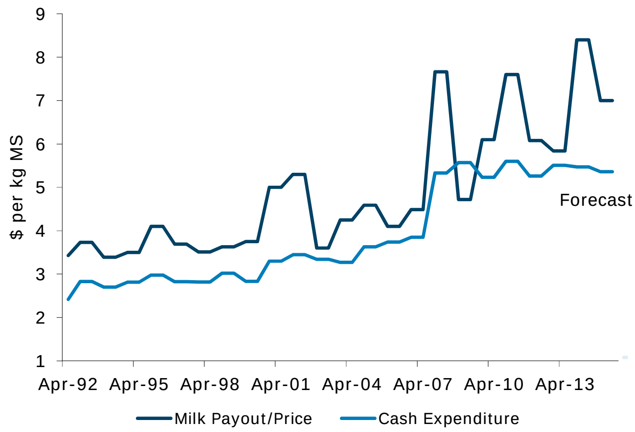
Source: ANZ, DCANZ

OPENING 2014/15 MILK PRICE FORECAST

For next season (2014/15) Fonterra has started with an opening milk price of $7/kg ms. While this milk price represents a substantial fall in percentage terms from the 2013/14 season, it is still the 4th highest on record and is above the seven year average of $6.63/kg ms. Unlike in prior bumper payout years, the cost line hasn't exploded upwards; that's an encouraging dynamic and means the rural sector is very well placed to absorb the payout falling (from extremely high levels), leaving profitability strong (refer chart on front page).

The dividend also needs to be added, and we expect that will be better than the current season's $0.10 per share. This is due to the realignment in reference and non-reference product prices that has recently taken place, an assumption there will be no more quality/product recall issues, and improving prospects for the Australian business. However, one thing to watch closely will be volume growth for 'value-add' products into Asia and other emerging markets, which seemed a little disappointing in the half-year results, especially when margins weren't adjusted for high input costs.

FIGURE 3. DAIRY MILK PRICE VS. CASH EXPENDITURE (INCLUDING INTEREST & RENT)



Source: ANZ, Fonterra

We have had a milk price forecast in the low-to-mid $7/kg ms range (we are at the lower end of the range at present) since February, and today's announcement is in line with this. This expectation is based largely on the upward-sloping price curve for milk powders evident since downward pressure started to emerge on prices. This reflects that our expectation of better prices ahead is widely shared. One can point to a number of factors supporting this argument. Chinese import demand will pick up once their seasonal milk production peak has passed and they work through accumulated imported inventory from the first quarter. The global supply response is maturing (although we are watching the US closely at present) and farm-gate prices are coming off in other parts of the globe. And finally, we anticipate a slowly depreciating NZD/USD over the second half of the season (although this might be more of a 2015/16 story).

On a historical basis a milk price above $7/kg ms is very good, and ensures decent profitability around the $2,000/ha mark for the average dairy farmer. That's down on the current season, but in dairying parlance, they are still milking it.

The **pessimists will point to the decline in the payout between 2013/14 and 2014/15 as a massive drag on the economy** (around $2.2 billion, or 1% of GDP assuming similar production levels to the 2013/14 season).

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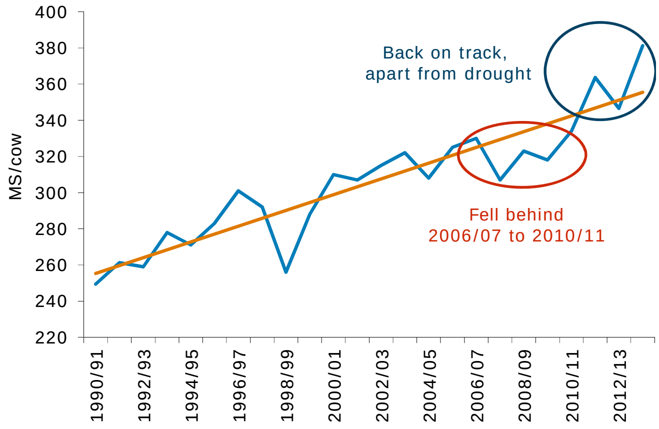
But **we see the glass as half full.**

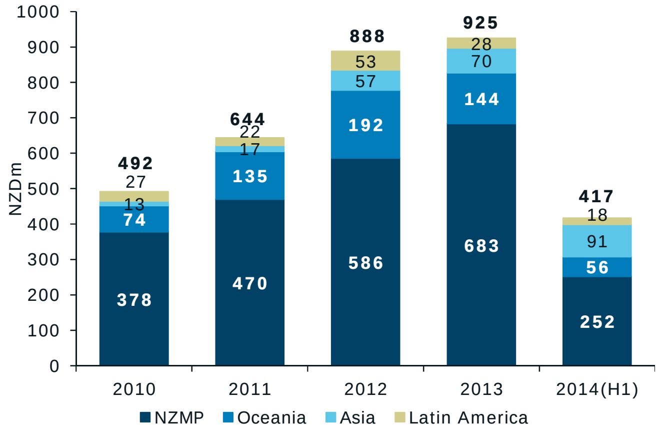
- **The 2014/15 milk price would still be the fourth highest on record if achieved;** sometimes economists get too caught up in changes and forget about levels.
- **From a spending point of view farmers will be in a similar situation over the coming 12 months as the previous year.** Actual cash paid out for the milk price over the last 12 months was $7.40 and we anticipate this will actually lift to $7.55 over the next 12 months. This is due to the historically high opening milk price and advance milk payment schedule, as well as the bow wave of cash from this year's milk price, which is paid out over the next couple of months (final payment end of October). Therefore, one shouldn't be fooled by the headline numbers and rather focus on what will be actually hitting farmers' bank balances over the coming year.
- **There is a stellar productivity story that's not hitting the headlines.** Total milksolids production is up by nearly 10% y/y to 1.825bn kg ms for 2013/14. This will eclipse the previous record set in 2011/12 by 8%. Perhaps more importantly, the average yield per cow is close to 381kg ms, a new record that confirms above-trend productivity growth over the past few years (+7.5%, or two and half years ahead of trend). This represents a remarkable recovery from the drought last year and reinforces some of the positive developments in farm systems, skill sets and behaviours in recent times. **As Fonterra's half-year results showed, the growth in milk supply has caught even them by surprise** – so much so they have decided to increase capital expenditure on new processing capacity by $400-$500 million (+16%) over the next three to four years and have plans to increase throughput at existing plants until the new capacity is built.

FIGURE 4. NZ'S AVERAGE MILKSOLIDS PRODUCTION PER COW



Source: ANZ, Dairy NZ, LIC

FIGURE 5. FONTERRA'S CAPITAL EXPENDITURE



Source: ANZ, Fonterra

- **From a long-term perspective the fall in the coming year's milk price might be a good thing.** That might sound like an oxymoron, but back-to-back high payouts would have been a red rag to a bull, likely fostering over-investment, unsustainable land prices, and too large a supply response around the globe. A supply response that is too large for the market to digest ultimately ends up in prices materially undershooting a season or so down the track, causing a lot of unnecessary volatility.

While the dairy payout grabs the headlines, we also keep an eye on the subtle nuances – those microeconomic forces that give indications of future direction – and let's face it, Fonterra is a nationally significant bellwether. **On this front we note Fonterra is not standing still.**

- **It is restructuring its Australian business** to get it on a more stable footing, as well as eyeing further acquisitions to expand its foot print in targeted segments.

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- **It has restructured its South American business to focus on wealthier segments and consumers in the likes of Brazil.** In such markets they are focusing on everyday nutrition offerings to add more value to milk.
- **Construction has started on a blending and packing plant in Indonesia. This is Fonterra's largest investment in new manufacturing in ASEAN in the last 10 years.** The new plant will support the growth of consumer brands such as Anlene™, Anmum™ and Anchor Boneeto™.
- **There is more corporate responsibility being shown** on issues from the affordability of dairy products for NZ consumers through to environmental issues. Not all these initiatives go down well with all farmer shareholders, but it is helping to improve the public's perception of the industry and keeps heavy-handed regulators at bay. Better to be proactive than reactive.

These are just a few recent examples of the investments Fonterra is undertaking to build and grow their consumer and advanced nutrition positions that add more value to raw milk. These are the stories that support medium-term growth and the outlook for the NZ dairy sector.

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