NEW ZEALAND DAIRY UPDATE

24 March 2017

CONTRIBUTORS

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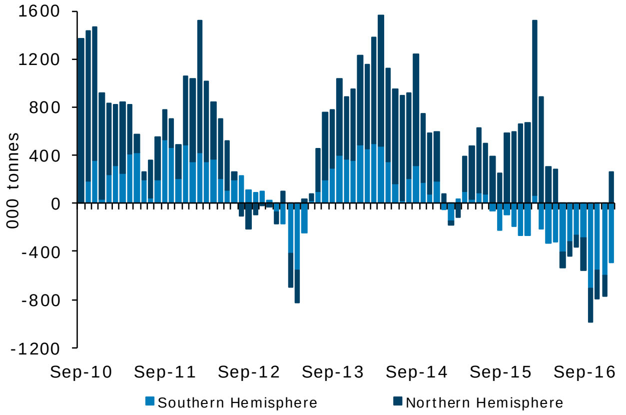
STEADY AS SHE GOES

- **We are forecasting a milk price of $6.10 to $6.15/kg MS in 2016/17** (down from $6.25/kg MS, but above Fonterra's $6.00/kg MS given recent GlobalDairyTrade movements for whole milk powder and milkfats). Changes to the milk price manual at the start of the season have also contributed an additional $0.06/kg MS at the expense of dividend earnings.
- **Fonterra's guidance on earnings per share was reduced to 45 to 55 cents** (earlier guidance was 50 to 60 cents per share). However, lower retentions by the Co-operative were implied, with the forecast full-year dividend paid to shareholders remaining at 40 cents per share. An improvement in Fonterra's balance sheet (largely due to a better working position) and reduced capital expenditure allow for lower retentions.
- **Fonterra's production outlook was further upgraded to -3% y/y** (having been as low as -7% into mid-February). This means higher autumn milk flows than recent years and given a falling market share for Fonterra, suggests total New Zealand supply will finish around ~1.5% y/y behind. Steady production (regional differences aside) and improved returns make for a more favourable total revenue and profit environment in 2016/17.
- **That said, the production upgrades equate to around 100,000 mt of wholemilk powder equivalents that the market will need to digest**. Recent upgrades to GDT supply (35,000 mt of powder added) suggests this channel has received its fair share, and a lower starting inventory position (-9% overall for Fonterra) and continued growth in non-reference milk sale products will allow some 'flex' to manage the increased supply.
- **Focus is turning toward the opening milk price forecast and advance rates for 2017/18, as these will set the tone for farm spending. We expect an opening forecast in the high-$5/kg for 2017/18.** 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 low-$6.00/kg MS in 2017/18 (using above forecasts, a similar dividend and excluding loan repayments). This improvement is largely driven by improved deferred payments compared with the prior two seasons.
- **With breakeven for the sector in the low-$5s, the sector is moving back into the black, though hardly flush with cash.**
- **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 metrics which will be further eroded with interest rates biased higher** (and still a large proportion of debt on short-term rates). However, there will be some natural uplift in spending related to cyclical costs that swing with the milk price (supplementary feed, grazing etc) and capital expenditure that was trimmed to unsustainable lows during 2014/15 and 2015/16.
- **Dairy markets will remain volatile.** While reduced supply lifted prices in late-2016, supply indicators are now pointing higher. The commodity complex globally still looks vulnerable to a turn in the reflation trade, though each commodity will be influenced by its own supply/demand characteristics.

WHERE ARE DAIRY MARKETS CURRENTLY POSITIONED?

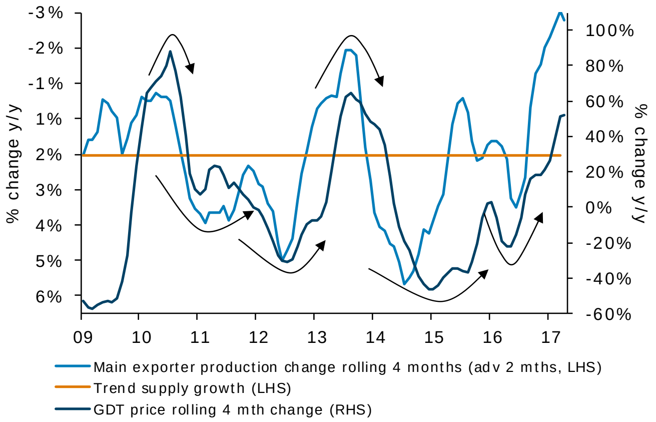
The cycle in dairy markets continues to be driven by supply conditions, specifically in the US, New Zealand and Europe. Supply conditions have improved across all the major export regions (outside of Argentina, due to floods) since the start of the year. Short-term milk flows are driven by farm-gate returns/margins, seasonality (weather and usual seasonal cycle) and supplementary feed prices. **All three indicators in the US, New Zealand and Europe point toward higher milk flows into mid-2017.**

FIGURE 1. MILK PRODUCTION GROWTH FOR MAJOR EXPORTERS



Source: ANZ, Dairy Australia, DCANZ, CLAL, Datum, USDA

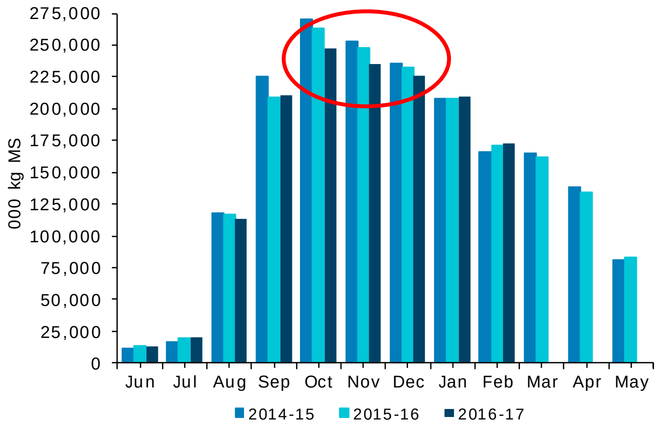
FIGURE 2. MILK PRODUCTION GROWTH VS GDT PRICE CHANGES



Source: ANZ, Dairy Australia, DCANZ, CLAL, Datum, USDA, GDT

Within New Zealand widespread rain fall in mid-February and early-March has improved pasture conditions, especially in the North Island. This has increased recent output, and will also extend days in milk for many herds that might have been dried off early if the rain hadn't arrived.

FIGURE 3: NEW ZEALAND MILK PRODUCTION



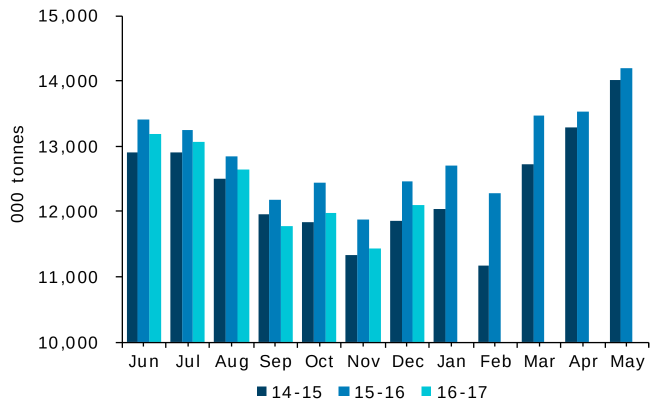
Source: ANZ, DCANZ

Fonterra further upgraded its production outlook to only a 3% y/y reduction for 2016/17 (having been as low as -7% into mid-February). Given a falling market share for Fonterra total New Zealand supply will finish around ~1.5% y/y behind.

The production upgrades equate to around 100,000 mt of wholemilk powder equivalents that the market will need to digest. Recent upgrades to GDT supply (35,000 mt of powder added in total) suggest this channel has received its fair share. A lower starting inventory position (-9% overall for Fonterra) and continued growth in non-reference milk sale products will allow some 'flex' to manage the increased supply into the market.

Offshore the main competitive threat is Europe, especially for whole milk powder and milkfats (excluding cheese). We believe European export pressure is set to increase over next six months as seasonal milk flows increase, but additional support is provided by improved farm-gate returns (in line with 5-year average and 20-25% above last year), lower feed prices than last year, and a low euro.

FIGURE 4: EUROPEAN MILK PRODUCTION

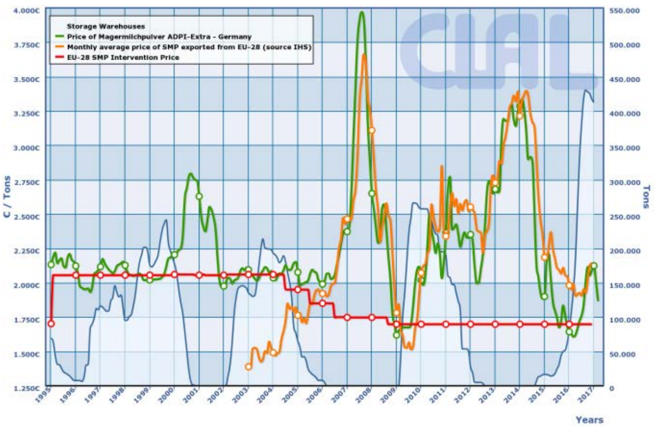


Source: ANZ, European Commission

That said, the stance of the European Commission will be important. Many support/regulatory mechanism remain in place and were actively used through the second half of 2016, including subsiding farmers to reduce milk supply (hitting Q4 milk flows). This was a crucial part of improving international returns through the second half of 2016.

The market remains fixated on the European Commission's aging skim milk powder mountain. Currently there are nearly 412,000 mt of skim milk powder in intervention storage (including private aid). This is the largest stockpile ever and equivalent to more than 90% of New Zealand's annual exports. So far the EC has been unsuccessful in tendering product on the open market and is obliged to add another 100,000 mt this year. With high cream and butter prices it would seem much of the increased milk flow over coming months is destined to be turned into SMP/milkfat (separation of milkfat and protein components). Combined with existing inventory levels, this suggests skim milk powder prices will remained weighed down for some time.

FIGURE 5: EUROPEAN SKIM MILK POWDER DYNAMICS

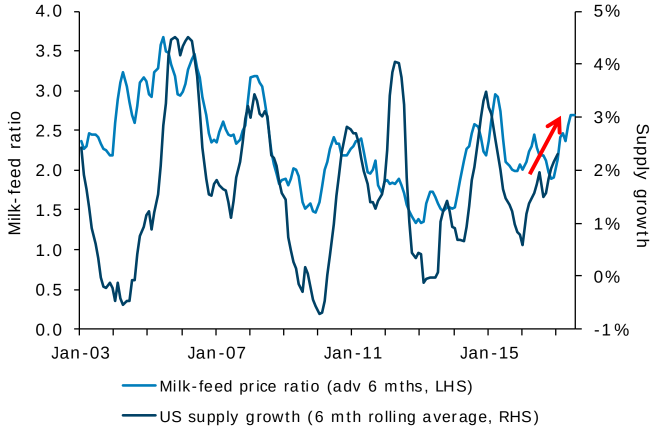


Source: CLAL

However, it remains to be seen how much of this product will make it into the commercial food grade channel and in what final form. A fair proportion is likely to end up in food aid programs, stock feed, or blended/manufactured into other products like casein. The other aspects processors will be wary of is that the European Commission is unlikely to extend intervention stocks this year beyond what it is obliged to buy given high starting inventory levels and farm-gate returns in line with 5-year averages. This could support some of the marginal milk flow being turned in whole milk powder, depending on the relative price signal from the different milk streams and European Commission's stance.

Elsewhere US supply looks set to accelerate too and California production (a key export state) is once again increasing due to improved water supplies. In the US case farm-gate prices 10-15% above the 5-year average and historically low feed prices are supporting margins, as well increased cow numbers.

FIGURE 6: US SUPPLY GROWTH VS. PRICE MARGIN SIGNAL



Source: ANZ, USDA

The export potential from the US is lower though, with the domestic market continuing to soak up marginal growth and a higher USD eroding the attractiveness of international markets vs. domestic. Much of the improved domestic backdrop centres around an improved economy (full employment, increasing wages and wealth); changing dietary patterns; and new health research. The movement away from sugar in a range of processed food products is supporting milkfat products (to a certain degree) as a replacement ingredient.

Since early 2016 the butter market has been driven by US consumers moving back toward natural products, with new research and health practitioners increasingly saying it's a better choice than alternatives which had taken market share over past decades. High tariff barriers and quotas limit the amount of butter that can be imported into the US with Europe having significantly better access to this market than New Zealand does. However, this has allowed New Zealand to focus on the Greater China and South-East Asian markets**. Cheese demand has been driven by a quite different trend of robust foodservice demand, where many menu offerings have a cheese component** (pizza, burgers etc). Growth in this area is more aligned with the improved economic conditions in the US.

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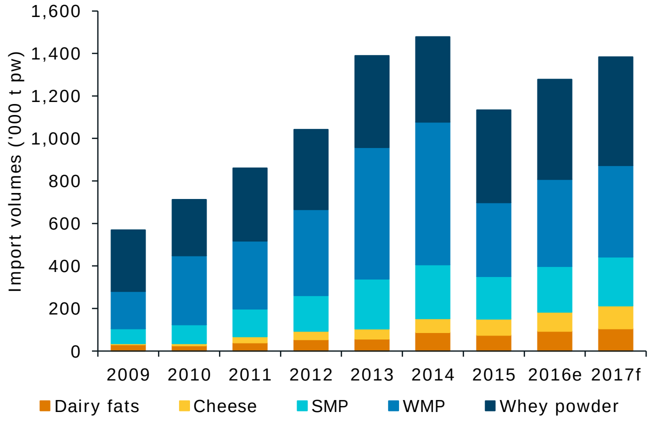
The other area of challenge for US dairy exports is trade tension with Mexico, who accounted for 25% of total export returns in 2016 (their largest market by some margin). On the skim milk powder front Mexico accounts for nearly half US exports. So any dislocation in US trade will need to be watched as this could increase competitive pressure into South-East Asian markets where US exporters have existing trade/business relationships. Whether New Zealand or Europe will pick up the slack in Mexico could depend on how quickly improved market access is negotiated – all adding to marketplace volatility.

On the demand side improved demand from the Greater China region and other strategic South-East Asian markets has been key. Generally, import demand from the Middle East/North Africa region has been softer due to ongoing conflicts in many countries and lower energy prices weighing on economies. The exceptions are Algeria and Libya, where imports of milk powder have surged to make up for a local deficit in fresh milk. It's difficult to see these trends changing much in the short term.

FIGURE 7: CHINESE DAIRY IMPORTS BY PRODUCT



Source: ANZ, Chinese Customs

Export performance into China and the broader South-East Asian region will remain key in 2017/18. The consensus view seems to be that Chinese imports will lift by another 10-20% in 2017 as local supply struggles to meet additional demand growth. If this occurs it would be difficult to see whole milk powder prices pushing below US$2,800/t for an

TABLE 1: NEW ZEALAND DAIRY EXPORTS – JANUARY 2017

MILK POWDER			MILK FAT			OTHER		
Country	**Last 12 months**	**% y/y**	**Country**	**Last 12 months**	**%y/y**	**Country**	**Last 12 months**	**%y/y**
China	1,764	4%	China	546	10%	US	699	-19%
Algeria	640	48%	Australia	416	23%	China	524	18%
UAE	348	-25%	Japan	303	-6%	Mexico	321	29%
Malaysia	290	-23%	Indonesia	133	13%	Philippines	226	5%
Sri Lanka	235	9%	Egypt	119	-23%	Japan	125	-18%
Thailand	210	-15%	Korea	119	30%	Netherlands	123	-31%
Indonesia	209	10%	Saudi Arabia	107	-9%	Egypt	116	0%
Vietnam	172	-20%	US	98	-10%	Thailand	98	-9%
Singapore	170	-19%	Taiwan	94	3%	Indonesia	92	5%
Bangladesh	158	12%	Philippines	91	5%	Malaysia	88	2%
Philippines	153	-9%	Iran	86	-9%	Russia	70	147%
Saudi Arabia	151	-31%	Malaysia	70	-1%	Australia	68	-3%
Taiwan	147	-19%	Morocco	58	17%	Saudi Arabia	68	-20%
Nigeria	141	-14%	UAE	57	-23%	Vietnam	68	3%
Egypt	127	0%	Russia	56	172%	Singapore	42	-48%
Libya	65	58%	Hong Kong	51	17%	Taiwan	41	3%
Sudan	61	16%	Chile	50	16%	Korea	38	-17%
Venezuela	58	-79%	Azerbaijan	42	-29%	Algeria	35	22%
Oman	50	-20%	Singapore	38	-15%	UAE	30	-4%
Australia	49	-8%	Turkey	37	-37%	Germany	30	-21%

Source: ANZ, Statistics NZ

extended period. In China local milk supply fell in 2016, with dry conditions in the North-West (the main producing region) impacting fresh milk supply and supporting imports. **Imported product also remains nearly half the local price, which should support imports at the expense of a strong bounce-back in local supply.** But as always, uncertainty is high and import demand for milk powder to supplement fresh milk supplies will continue to swing with local supply conditions.

A changing import mix into China is underpinning growth as consumer trends change and regulation shapes sourcing relationships. The infant formula category continues to grow despite regulatory change to reduce the number of brands and boost breast-feeding rates. An increasing birth-rate from changes to the one-child policy appears to be providing a tail wind. In this space New Zealand continues to see a rise in not only direct infant formula sales, but also bulk base formula powder that manufacturers then use to produce infant/child formula.

The other growth area that shone through in Fonterra's half year results was consumer and foodservice sales in Greater China. Indeed Fonterra's consumer & foodservice operations increased EBIT +30% in the first half of 2017 versus the same period a year before (although -8% on 2H16). Volume and margin expansion into China (+32%, +16% respectively) were the key drivers of the uplift.

So it seems the targeted strategies of sending products into specific market segments where the Co-operative has a competitive advantage is paying off. The foodservice strategy, for example, is focused on the bakery, hotel, restaurant and café channels with five product categories of UHT cream, cream cheese, butter, mozzarella and speciality products. The reality is these segments and the westernised component, where dairy more easily fits in, is only a small part of the out-of-home food market, but market share gains, combined with organic growth, make for a favourable mix. The same sort of strategies into other focus markets in South-East Asia look to be providing demand support (as seen in Fonterra's financial results and trade statistics).

SO WHAT DOES IT ALL MEAN FOR FARMGATE RETURNS?

We remain alert to the possibility of a turn in the global reflation trade which has buoyed the wider commodity complex. Some commodities (i.e. oil) have shown signs of tapering (though partly influenced by supply-side dynamics) and market price action is increasing looking for hard evidence of policy initiatives in the fiscal arena to support global growth. Questions are starting to surround the ability of the US Government to drive through tax reform and boost infrastructure spending. The pending health vote is being seen as an acid test of the ability to drive through wider policy initiatives in the US. At the same time, impetus from China's stimulus package (which kicked off the reflation trade) is starting to fade and their inventory cycle rebuild looks complete for some commodities. So the international backdrop contains a huge layer of uncertainty, and that is before we overlay growing nervousness in regard to the direction of trade policy.

While we are cautious on the global picture, the supply-demand characteristics of individual commodities also holds huge sway.

For international dairy prices it looks like we'll see a continuation of trends seen in 2016, namely the under-performance of skim milk powder, but a solid performance for milkfat and wholemilk powder. The main risk is that milk flows from New Zealand, Europe, Australia and the US all increase too much into mid-2017, overwhelming all tradable markets.

The main risk for wholemilk powder seems to be that domestic milkfat demand in the US and Europe can't completely soak up the increases in marginal milk. This would lead Europe to compete more vigorously in New Zealand's main milkfat markets (reducing prices) and the price signal would incentivise both European and New Zealand producers to substitute towards producing more wholemilk powder (limited wholemilk powder capacity aimed largely at the domestic market limits the same direct risk for the US). **The other main risks are higher New Zealand supply, lower Chinese demand and a general downturn in all commodity prices.**

On the New Zealand supply front, while short-term milk flows are biased higher through autumn, a year-on-year comparison suggests overall milk supply is fairly stable. Most of the short-term supply increase already seems to have been accounted for on the GDT and via other sales channels/products. Overall inventory levels are reportedly low across Oceania (Fonterra -9% y/y for example) and China too.

At the same time, the consensus view is that Chinese imports are set to increase further in 2017, a notion that has been supported by high participation from North Asia at recent GDT auctions (usually lower at this time of year). **This suggests the bounce in wholemilk powder prices back above**

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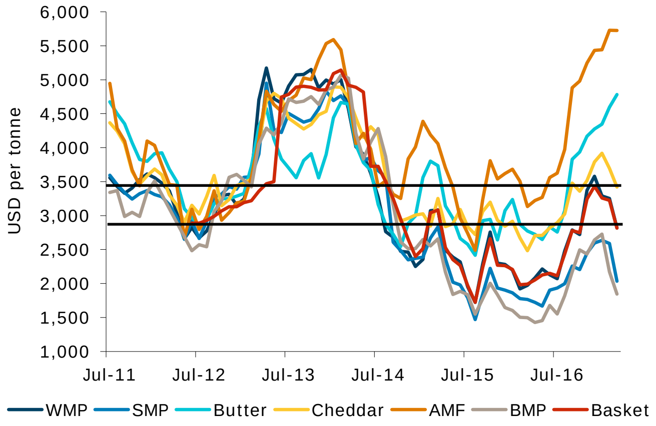
US$2,800/t at the latest auction provides somewhat of an anchor when looking forward into 2017/18. It also happens to be the bottom of our long-run price band for whole milk powder of US$2,800/t to US$3,400/t, with a mid-point of US$3,100/t (refer to our August 2015 *Agri Focus*).

FIGURE 8: INTERNATIONAL DAIRY PRICES



Source: ANZ, GDT

Of course to get back to a farm-gate return the currency also needs to be considered. **Our current forecasts are for the NZD/USD to head back to 0.68 by the end of 2017.** So using this currency assumption, a WMP price of USD2,800/t, SMP at intervention prices and factoring in a slight moderation of milkfat prices delivers a milk price in the high-$5/kg MS for 2017/18. This would pretty much be in the middle of our long-term band of $5.50 to $6.50/kg MS.

TABLE 2: POSSIBLE MILK PRICE SCENARIOS

Fonterra Milk Price Component Scenarios (NZ$ per kg MS)					
		NZD/USD			
		0.65	0.68	0.71	0.74
WMP (US$/t)	2,500	5.60	5.30	4.95	4.65
	2,600	5.80	5.45	5.15	4.85
	2,700	6.00	5.65	5.30	5.00
	2,800	6.15	5.80	5.45	5.15
	2,900	6.35	6.00	5.65	5.35
	3,000	6.55	6.15	5.80	5.50
	3,200	6.90	6.50	6.15	5.85

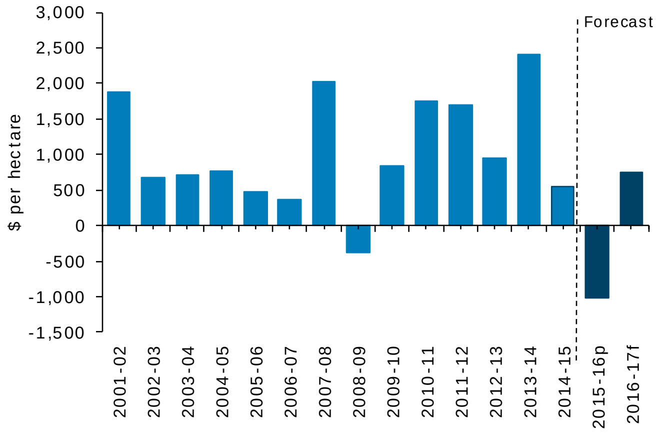
Source: ANZ, xxx

For 2016/17 we are now forecasting a milk price of $6.10 to $6.15/kg MS (down from $6.25/kg MS in late November) with the season circa 90% sold. Changes to the milk price manual at the start of the season have also contributed an additional $0.06/kg MS at the expense of dividend earnings.

From a cashflow point of view the above forecasts, combined with the overall production improvement, translate into a more positive total revenue environment. For the average fully shared Fonterra supplier 2016/17 is set to deliver $5.75/kg MS. Using the above forecasts, a similar dividend and excluding loan repayments, cashflow improves into the low-$6/kg MS range for 2017/18. This improvement is largely driven by much better (normalised) deferred payments compared with the prior two seasons.

For the average farmer the improved cashflow, combined with other cost efficiencies put in place, pushes profitability before tax back toward $705/ha. This is slightly below the 10-year average of $920/ha, but much better than the 2015/16 season!

FIGURE 9: AVERAGE DAIRY FARM PROFTABILITY (INCLUDING FINANCE COSTS)



Source: ANZ, Dairy NZ

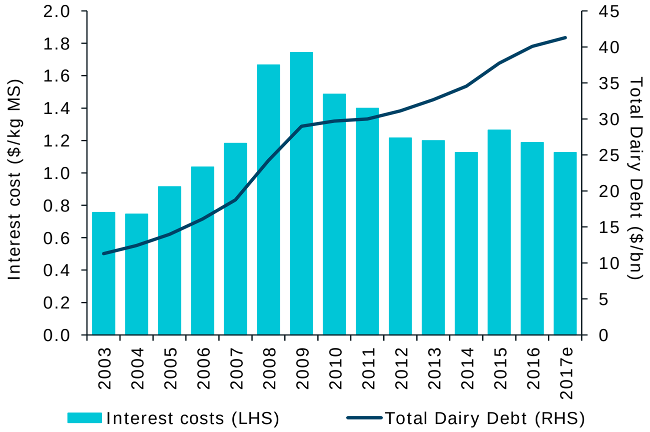
A big focus for many will be debt repayment from the very poor 2015/16 season. The sector accumulated circa $1.50/kg MS of debt during this period – this will need to be reduced to restore many businesses' balance sheet strength to where it was prior to the sharp downturn. This is needed in many cases to weather the volatility in dairy markets (highlighted repeatedly by Fonterra in its half year results and recent price movements for WMP on GDT). The other reason for focusing on debt repayment is that interest rates are biased higher. This will bring additional costs with higher debt levels.

For Fonterra suppliers repayments of loans drawn down from the Co-operative in 2015/16 will be the first port of call. However, there will be some natural unwind for spending related to cyclical costs that swing with the milk price (supplementary feed, grazing etc) and repairs/maintenance/capital expenditure that was trimmed to unsustainable lows during 2014/15 and 2015/16 too.

Repayment of Fonterra loans is triggered when the monthly cash advance moves above $6/kg MS. So if the end milk price is $6.10-$6.15/kg MS for 2016/17 then for many the extra $0.10-$0.15/kg MS will head toward loan repayments. This will only occur in deferred payments in 2017/18. **Around 76% of Fonterra suppliers took up loans of circa $383m, which across the entire Co-operative's milk supply is around $0.25/kg MS, but over the suppliers that drew down the loans is $0.33/kg MS.**

To emphasis the tailwind lower interest rates have provided to cashflow/profit in the dairy sector it's useful to look back to the GFC period and compare with current underlying debt levels, interest rates and interest servicing costs.

FIGURE 10: DAIRY DEBT DYNAMICS



Source: ANZ, Dairy NZ, RBNZ

Back in 2009 the average debt was $20.80 per kg milksolid and the average interest rate was 8.4%. This gave a peak interest servicing cost of $1.75/kg MS in 2008/09. **Fast forward to now and the sector's total debt load has increased by 42% to a touch over $41 billion, but due to the growth in milksolid production, debt per MS has increased a more reasonable 8% to $22.50/kg. Combined with the effective interest rate dropping to 5% this has seen interest-servicing costs decline to circa $1.15/kg MS. This has added an additional $0.60/kg MS to cashflow over this period.**

The challenge now is with interest rates biased higher, underlying debt loads having increased, and a significant proportion of debt on short terms this tailwind is set to become a headwind. **To highlight the issue: if interest rates were to push back to 8.4% over the next several years interest servicing costs would increase to $1.90/kg MS, up $0.75/kg MS.** Each 1% movement in interest rates is worth $0.23/kg MS in cost.

This, combined with milk prices remaining volatile, highlights the need for balance sheet strength to weather downturns and protect cash margins.

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