Media release

24 September 2015

Fonterra Strengthens Second Half Performance in 2014/15

Highlights

- Total sales volumes up 9% at 4.3 million metric tonnes
- Revenue $18.8 billion, down 15%
- Normalised EBIT $974 million, up 94%
- Net profit after tax $506 million, up 183%
- Cash Payout $4.65, down 45%
  - Farmgate Milk Price $4.40 per kgMS
  - Dividend of 25 cents per share
- 2015/16 forecast total available for payout up 75 cents to $5.00 − $5.10 per kgMS

Annual results

Fonterra Co-operative Group has announced a net profit after tax of $506 million for the financial year ended 31 July 2015 - up 183 per cent - after a stronger second half performance in difficult market conditions.

The Co-operative will pay a final Cash Payout of $4.65 for the 2015 season for a 100 per cent share-backed farmer, comprising a Farmgate Milk Price of $4.40 per kgMS and a dividend of 25 cents per share.

Chairman John Wilson said extremely challenging trading conditions globally had affected all parts of the Co-operative's business.

"Falling global dairy prices due to a supply and demand imbalance impacted the Milk Price, while the dividend reflected higher funding costs following significant investment in capacity to support milk growth in New Zealand, essential investments in the key strategic market of China, and the costs of maintaining a higher Advance Rate through the season.

"The strengthening of performance in the second half resulted in normalised earnings before interest and tax almost doubling, with good growth in our consumer and foodservice businesses and the results of a major push in our ingredients business to offset low milk prices with improved margins."

Cash interest costs on funding were up $95 million to $427 million, which had an impact of around 6 cents per share.

Mr Wilson said that despite drought in some regions and floods late in the season, milk collection across New Zealand for the 2014/15 season to 31 May 2015 was 1,614 million kgMS, up two per cent on the previous season.

Strong Volume and Value Growth

Chief Executive Theo Spierings said improved second half results in the 2015 financial year were driven by a strong focus on cash and costs.

“We focused on improving our sales mix, achieving more efficiencies, maximising our gross margins and achieving our strategic goals faster. Our efforts contributed to a second half rebound in our performance and profitability.”

Normalised EBIT for the group was $974 million, up 94 per cent. The ingredients business’ efforts to offset low milk prices with improved margins increased ingredients normalised EBIT by 43 per cent to $973 million. Consumer and foodservice normalised EBIT increased 216 per cent to $408 million.

“Significant progress was achieved in our consumer and foodservice strategy where we are aiming to win hearts, minds and especially market share in our eight strategic markets of New Zealand, Australia, Sri Lanka, Malaysia, Chile, China, Brazil and Indonesia. With the reorganisation of Dairy Partners Americas completed, consumer and foodservice volumes were up a significant 27 per cent to 1.7 million MT,” said Mr Spierings.

“Our Asia and Greater China consumer and foodservices businesses, which source most of their milk from New Zealand, were also important contributors to this result.”

In the 2015 financial year, investments in capacity and maintenance in New Zealand included: the $167 million to complete the Pahiatua dryer and distribution centre; $132 million in the anhydrous milk fat, milk protein concentrate and reverse osmosis plants at Edendale; and the $122 million investment in the dryer at Lichfield due for commissioning in 2016. Combined they represent 8.2 million litres additional capacity.

“Our new plants stand out in terms of efficiency gains and a more flexible product mix. In the second half we optimised our product mix, favouring products where we could secure higher prices, such as cheese and casein, to capture shifts in customer demand,” Mr Spierings said.

“Our $230 million investment in the past two years on capacity to support our consumer and foodservice performance is generating the volume and value growth we want, especially in Asian markets.

“Our return on capital for the Group was 8.9 per cent. Our ingredients business’ return on capital was 9.3 per cent and our consumer and foodservice business achieved a return on capital of 25.5 per cent,” said Mr Spierings.

With capacity now more in line with current expectations of milk growth, the Co-operative would have a reduced capex spend in 2016 of $900 million.

Mr Spierings said this year’s difficult market conditions were shaped by a rare combination of factors.

"Prices are often cyclical, but this year’s market is one of the most difficult I’ve known. The global dairy industry has been hit simultaneously by geopolitical turmoil in the Middle East and Russia, Ebola in Africa, an economic slowdown in China and the sharp drop in oil and mineral prices. These events suppressed demand at a time when farmers all around the world had ramped up production in response to previous high prices. This resulted in an inevitable impact on pricing.

“Looking ahead, this uncertainty means that world markets are likely to be difficult in the medium-term. However, we will be more than ready when the market turns.

“That’s because we have thoroughly reviewed our execution of strategy, our processes and working practices to embed long-term change. We are focusing all our resources to make us faster, more efficient, and achieve sustainable results,” said Mr Spierings.

Fonterra’s business review is an on-going process across the whole organisation to identify areas where the Co-operative can find more efficiencies and improve future performance.

This on-going review is targeting one-off cash savings and recurring cash savings from across the business including procurement, operations, supply chain and sales mix. These cash savings are expected to build over the next 24 months and, as they are realised, will impact Milk Price, earnings, cash flow and the balance sheet.

“Our business review is about always pursuing the full potential of our Co-op so we are in the best position to drive performance now in these challenging times and when global conditions improve,” said Mr Spierings.

Global Outlook

The Co-operative is lifting its forecast Farmgate Milk Price for the 2015/16 season to $4.60 per kgMS, an increase of 75 cents.

It has also reduced its New Zealand forecast production volumes by at least five per cent compared with the previous season.

The forecast total payout available to farmers in the 2015/16 season is now $5.00 − $5.10 per kgMS, comprising:

- Forecast Farmgate Milk Price $4.60 per kgMS
- Forecast earnings per share range of 40 - 50 cents per share.

Mr Wilson said the lift in profitability in the second half of the 2015 financial year was expected to carry through into the current financial year.

“Our track record this year in growing consumer and foodservice, along with our ingredients margins, make us confident in our forecast earnings per share range of 40-50 cents,” said Mr Wilson.

An update on the outlook will be provided at Fonterra’s Annual Meeting in November.

2014/15 Dividend Payment

The dividend of $0.25 per share comprises an interim dividend of $0.10 and a final dividend of $0.15. Record date for the final dividend is 8 October 2015, with a final dividend payment date of 20 October 2015.

The dividend reinvestment plan (DRP), under which eligible shareholders and unit holders can elect to reinvest all or part of their cash dividends in additional shares or units, will be made available in respect of the 2015 final dividend. The Board has determined that shares and units will be issued at a 2.5% discount on the average of the daily volume weighted average price for the period 6-12 October 2015. Participation election notices for the final dividend DRP must be received by 9 October 2015.

The Annual Results presentation, the Annual Review and the Financial Statements & Statutory Information are available on our website www.fonterra.com

NB: All dollars quoted are New Zealand dollars

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Business units

Ingredients

Our New Zealand ingredients business delivered a solid performance. This was mainly due to improved margins which were up $264 million. We adjusted our product mix away from reference products like Whole Milk Powder (WMP) towards non-reference products such as cheese and casein, and took advantage of better pricing opportunities in Japan and the United States. This, together with our differentiated product and service offerings, resulted in an improved second half and full year

normalised EBIT for the ingredients segment of $973 million, up 43 per cent compared to last year.

This was partially offset by an adverse product mix in ingredients manufactured in Australia as a result of lower sales of nutritionals and the fire at our Stanhope cheese factory in December 2014. The lower revenue reflected the relatively high domestic milk price in Australia, which is an intensely competitive market for milk supply.

We are taking steps to address product mix issues, including investigating the rebuilding of the Stanhope cheese facility. Our Beingmate partnership will help ensure Darnum returns to producing higher-value nutritionals.

The ingredients segment sales volume was two per cent lower at three million MT, as a result of lower sales of dairy ingredients to China, largely offset by higher sales in other regions. Revenue was 27 per cent down, reflecting the 36 per cent lower dairy prices compared to last year.

Consumer and Foodservice

Our consumer and foodservice segment delivered a strong result with normalised EBIT of $408 million, up 216 per cent compared to last year. The growth was mainly due to a record performance from our key markets, Asia and China, with strong volume growth. In addition, lower input costs for Asia, China and New Zealand (the regions that source their product from New Zealand) improved margins significantly.

In Australia our domestic foodservice business increased volumes by 10 per cent after five years of flat volume. We have implemented a number of initiatives to improve margins in our Australia consumer business. We have taken a $108 million write-down of the yoghurt and dairy desserts assets reflecting the continuing challenges in that business' market environment.

Total consumer and foodservice volume rose 27 per cent to 1.7 million MT. This increase was largely due to the Dairy Partners Americas (DPA) Brazil and Venezuela businesses being fully consolidated in our accounts for the first time, contributing 324,650 MT. We achieved like-for-like volume growth of three per cent. In Asia and Greater China volumes were up four per cent and 33 per cent respectively, contributing to a volume-driven increase in normalised EBIT of $41 million. The restructure of DPA generated $100 million in cash.

International Farming

We have two farming hubs with a total of seven farms producing safe, high-quality raw milk.

Sales volume of raw milk for the year increased to 164,000 MT largely due to additional capacity coming online. This equates to 12 million kgMS of milk produced for the year.

A normalised EBIT loss of $44 million reflected a decrease in the realisable raw milk price, farm development costs and a decrease in fair valuation in livestock, partially offset by significant operational efficiencies.

In the prior period the livestock values saw a significant uplift reflecting milk price and the herd profile assumptions at the time. The revaluation gain in the prior period was not repeated this year. For the full year, there was a revaluation loss of $3 million.

Future investments in China farms may include funding from strategic partners as well as Fonterra, enabling future and continued integration.

In total, capital expenditure for the year was $364 million. These funds were used for the completion of Fonterra's Ying and Yutian Hubs in addition to the ongoing construction of the farm effluent treatment systems. The total spend is inclusive of the purchase of livestock.

Non-GAAP measures

Fonterra uses several non-GAAP measures when discussing financial performance. For further details and definitions of non-GAAP measures used by Fonterra, refer to the Glossary in Fonterra's 2015 Annual Review. These are non-GAAP measures and are not prepared in accordance with NZ IFRS.

Management believes that these measures provide useful information as they provide valuable insight on the underlying performance of the business. They may be used internally to evaluate the underlying performance of business units and to analyse trends. These measures are not uniformly defined or utilised by all companies. Accordingly, these measures may not be comparable with similarly titled measures used by other companies. Non-GAAP financial measures should not be viewed in isolation nor considered as a substitute for measures reported in accordance with NZ IFRS.

- Fonterra calculates normalised earnings by adding back depreciation, amortisation, net finance costs, taxation expense and normalisation adjustments to net profit for the period.
- Normalisation adjustments are transactions that are unusual by nature or size so that they materially reduce the ability of users of the financial results to understand the on-going performance of the Group or operating segment to which they relate.
- Unusual transactions by nature are the result of a specific event or set of circumstances that are outside the control of the business, or relate to the major acquisitions or disposals of an asset/group of assets or business.
- Unusual transactions by size are those that are unusually large in a particular accounting period that is not expected to repeat regularly to the same extent in future periods.
- Normalisation adjustments are determined on a consistent basis each year.

Reconciliation of normalised earnings to reported profit

	GROUP $ MILLION	
	31 JULY 2015	31 JULY 2014
Profit for the period	**506**	179
Add: Net finance costs	**518**	366
Less: Taxation credit	**(82)**	(42)
Total EBIT	**942**	503
Add: Impairment of assets in Australia	**108**	–
Add: Restructuring and redundancy provisions	**33**	–
Add: Time value of options	**20**	–
Less: Gain on Latin America realignment	**(129)**	–
Total normalised EBIT	**974**	503