

# NZ Dairy Industry Report 2015

## Executive Summary

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*TDB confirms that it has no conflict of interest that could affect its ability to provide an unbiased report, but for completeness it is disclosed that in the last 12 months has advised on:*

- *the sale of shares in Open Country Dairy Limited;*
- *the sales of shares in Miraka;and*
- *the acceptance of Fonterra's guaranteed milk price offers.*

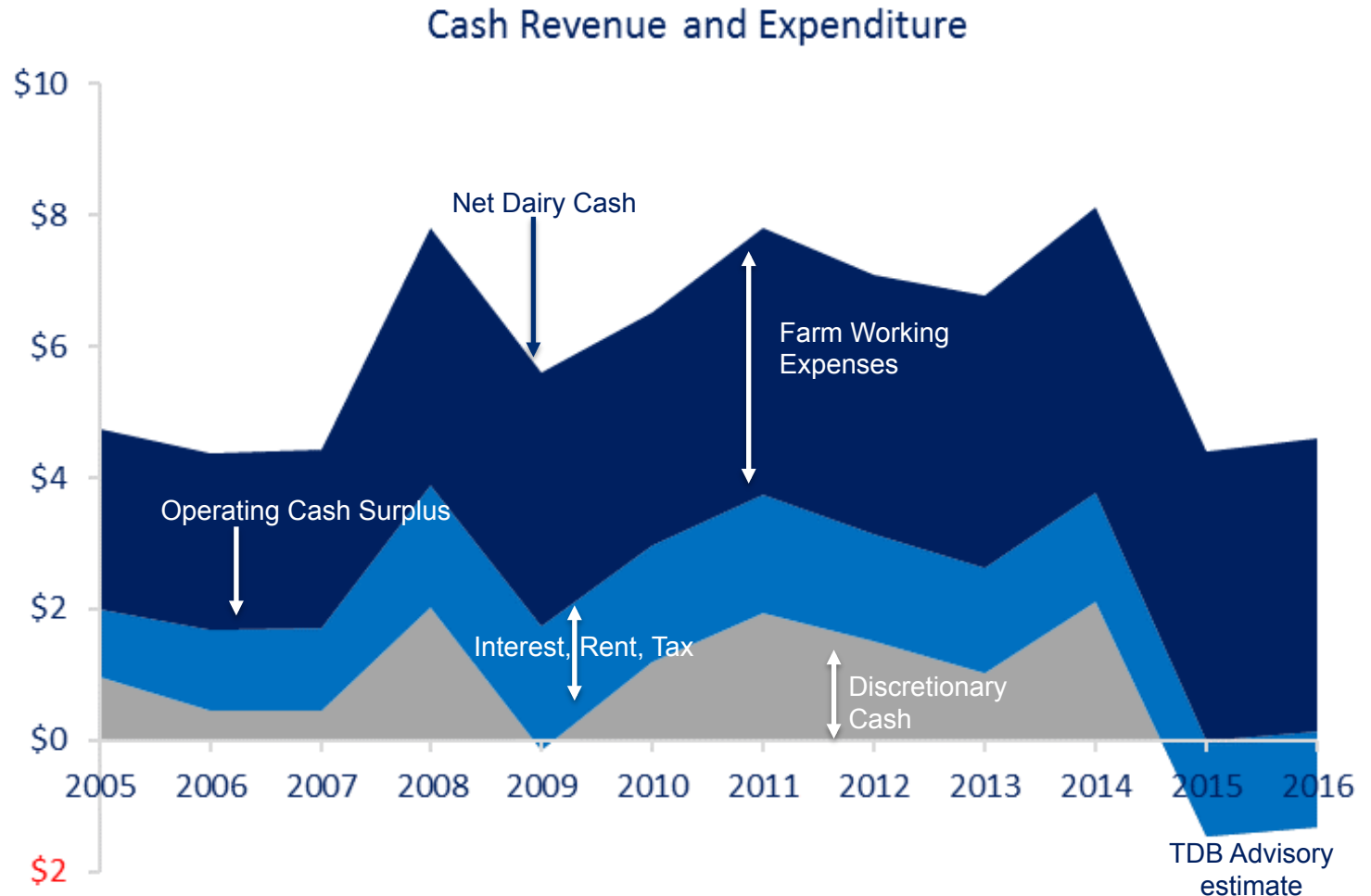
*The principal contacts for this report as disclosed above are:*

- *investors in Fonterra (FSF) shares;*
- *investors and former directors of Open Country Dairy Limited; and*
- *directors of other dairy farming business that are all Fonterra suppliers and shareholders, Synlait suppliers, and MyMilk suppliers.*

## Executive Summary

- Second year in a row of negative cashflow on-farm likely to result in:
  - lower land and cow values
  - higher dividends on Fonterra shares
  - a focus on lower farm working expenses and, from that, lower milk volumes
  - bad debt provisions by lenders and an increase in credit margins
  - asset sales to realise cash (and reduced capex spend)
- WMP price rises implied in futures pricing are needed to get farmers back above breakeven for 2016/17:
  - FX hedging policies mean a significant fall in NZD will only now flow into 2016/17 payout year
  - forward pricing for the start of next payout year (WMP future and hedged forward FX rate) at about \$6
- Processors' EBITDA growth will continue on:
  - lower milk prices
  - product mix
  - Improved capacity utilisation
- Processors' variations in product mix and FX hedging policies will further increase differences in milk payments received by farmers

Cash surplus was covering interest adequately until 2014....but now we are in our second year of having to go to the bank to capitalise interest.....



## Implications for farmers – begin positioning for 2016/17 being potentially the third year of losses

- Underweight cows - prices could fall materially
- Underweight land - could come back by 15%
- Overweight shares - continued growth in profitability of processors (Fonterra and competitors)
- Review Dairy processor choices:
  - greater milk price differentiation
  - on average new processors are paying higher base milk prices than Fonterra
  - risk has now fallen with new processors through the start-up phase of low capacity utilisation. Retained profits have reduced debt compared with Fonterra
- Look at the merits of fixed milk price offers:
  - However Fonterra is dropping its guaranteed milk price for next year
  - USD WMP futures may be an effective hedging alternative for some farmers
  - NZX is apparently developing a NZD futures contract in KGMS
  - Fonterra's competitors are at different stages of offering fixed price alternatives

## Comparative and forecast performance of Dairy Companies

- Profitability
  - profit outlook good for all from:
    - lower milk costs
    - product mix
    - improved capacity utilisation
  - commodity processors (Open Country and Miraka) now higher returning (EBITDA) than the regulatory costs of capital and Fonterra/NZMP
  - Tatua most profitable
- Risks
  - as Fonterra's leverage has increased, others have reduced risk as they have moved past the start up phase and profits have been retained and debt repaid
  - lower milk volumes are reducing forecast capex investment
  - regulatory review suggests not yet enough competition at factory gate so enabling provisions in DIRA for new competitors will remain in place for longer (would have been lower risk for all established processors to have increased barriers to entry)



## Implications for processors

- Increased volatility and potentially increased demand from farmers wanting to release capital from Fonterra is an opportunity for independent processors to de-link milk price from FGMP
- Review FX policies
  - Fonterra has the right to embed the negative value of FX hedges into the farm gate milk price
  - so the safest approach remains to “match” Fonterra. Either that is getting harder to do or independent processors are consciously deciding to develop their own FX policies as variations from Fonterra are getting larger
- Review interest rate risk management policies – not as material as FX risk but it appears there is greater variation across competitors than with FX risk policies
- Opportunities to reduce risk for both the processor and farmer by:
  - monitoring product mix values compared with Fonterra and communicating value differences early, and
  - investigating using undrawn borrowing facilities and GDT futures to pass down profits to farmer suppliers more quickly than the traditional deferred industry timetable
- Capture lower risk margin for suppliers by moving to toll processing income streams