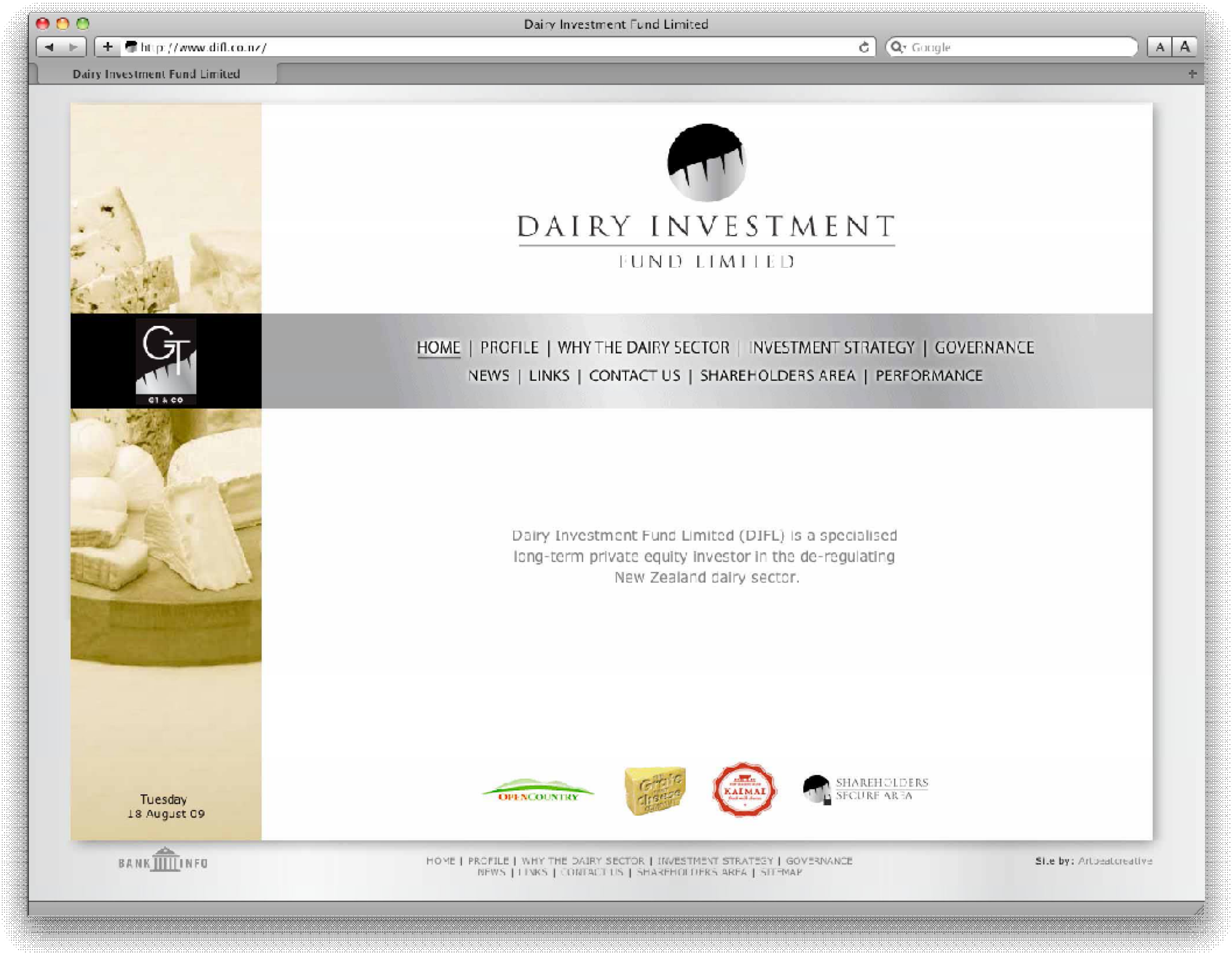
Executive Summary - Dairy Industry Investment Review 2009
(the full report is in the shareholders section of www.difl.co.nz)



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Exec Summary – poor in the short term, but medium term better than ever?

The good

- NZ in low cost position on the back door of Asia
- No one is making margin in dairy export (supply) countries
- Yes the world is short of protein
- Forward prices for soft commodities are materially higher than spot
- Forward pricing of milk is steeply positive (implies back above NZ $5.00)
- 2010 NZ returns of $4.50 are both a industry breakeven point and a floor in the price
- History of operating cost falls (in pastoral based farms in NZ) is in line with milk price falls
- The need for the NZ industry to de leverage will create an environment for transformational change within Fonterra (why have your lazy equity employed up in Fonterra when you are being forced to sell to sell one of your farms)
- Short term distress = asset sales = good for new entrants
- Profitability will be restored in the off farm (up stream) assets of the sector, this will help to recapitalise the sector (the offshore and domestic consumer will pay)
  - Fonterra value add
  - Mainland, Anchor
  - GF dairy business
  - OCD
  - Kapiti, Kaimai, Puhoi....
- To big to fail
- Floating rate currency

The bad

- Too much growth built into current dairy farm prices – they will fall further
- This cycle in dairy is different...more leverage and higher costs of capital
- Too much debt on farm and in Fonterra
  - Approx 33 billion of debt with EBIT for industry falling below interest costs at about $4.50 per KGMS
- Affordability will be have to be re-established through lower capital values and operating margins (2010 looks worse than 2009))
- A high proportion of the milk growth has come from a new style intensive, high cost dairy system
- Time to ruin for these intensive dairy operations is short:
  - Costs above $3.50
  - Debt above $22 KGMS
- Very uncertain what a dairy farm is worth at the moment but we estimate fair dcf value is approx $25,000 per Ha
- About 10% of NZ dairy farms have negative equity, based on our (DCF) valuations
- The reduction in on farm expenditure may reduce NZ milk production by more than is expected (that means share redemptions from Fonterra)
- Companies downstream from farmers will underperform...ouch
- Offshore milk subsidies are the biggest risk to forward NZ milk prices and therefore industry value

The Outlook

The winners

- Close to the consumer dairy businesses:
  - Fonterra "value" add business
  - GF dairy business
- Independent processors (farmers will want to release equity from F)
  - OCD
  - Synlait (the processor)
  - NZDL
- Low cost pastoral based farms
  - Waikato, Taranaki farms with low cost, low debts and high stores of fertility
- Fonterra Bonds
  - low risk, adequate yield
  - Effectively backed by the whole industry
  - "option value" as may be repurchased if capital structure changes effect Fonterra ratings

The losers

- High cost intensive farms in Canterbury, Cent Nth Island, North Otago and recent conversions in Southland
  - Equity syndicates with cost above $3.75 and debt above $20 Kgms (about 10% of the industry)
  - Synlait (the farm)
  - WIP conversions
  - Anything with irrigation costs and development capex
- Industry lenders overweight the above
  - Rabobank
  - ASB
- PGW, AFL, Fertiliser and Feed suppliers
- Industry employees
- The dairy consumer (prices will not fall by as much as commodity milk prices)

Farms, cows and others

Farms - a 13 billion fall in 2009 to 43 b

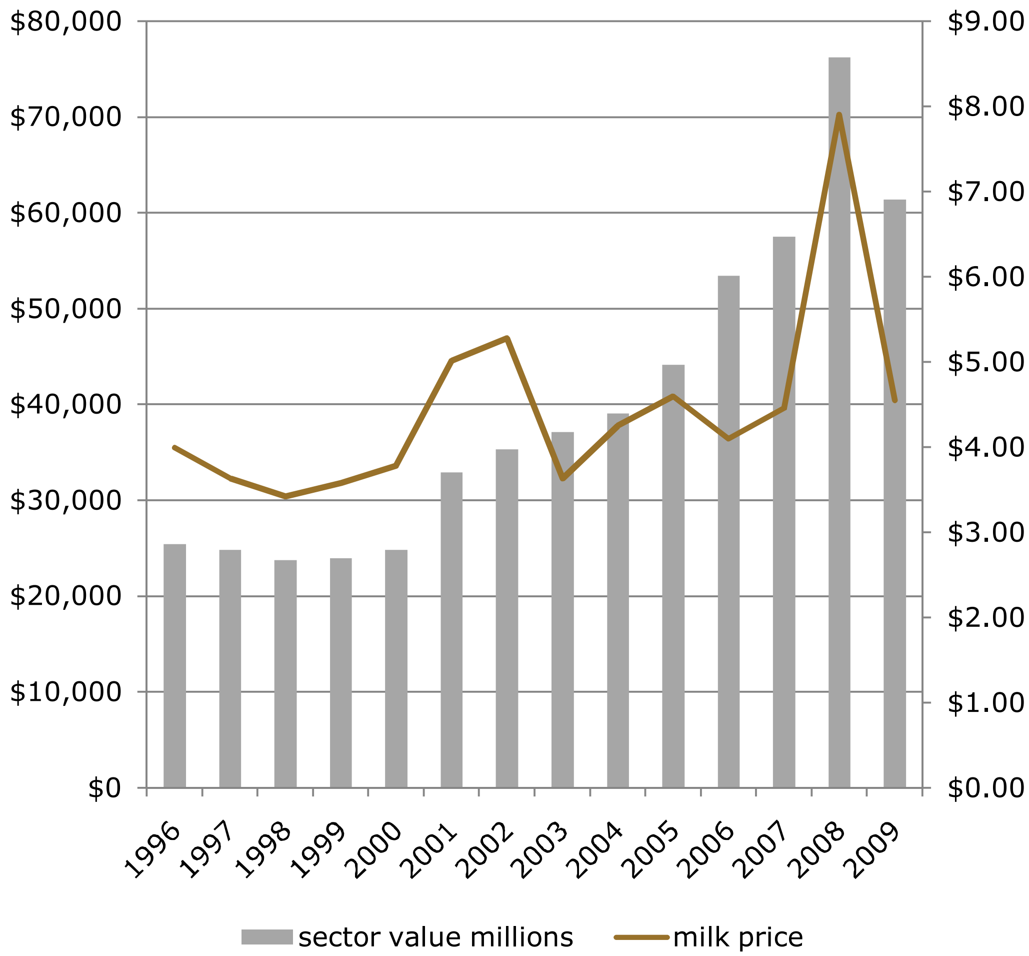
- Values are correlated to EBIT per Ha
- **Will fall further - analysis later in report**
- Worst effect will be intensive farming (high costs systems) in Cant, Sthland and Central North Island

Cows – the biggest percentage fall of 35% in 2009

- **Values down to 5 b**
- Not a good time to be a sharemilker
- Will get worse as production falls

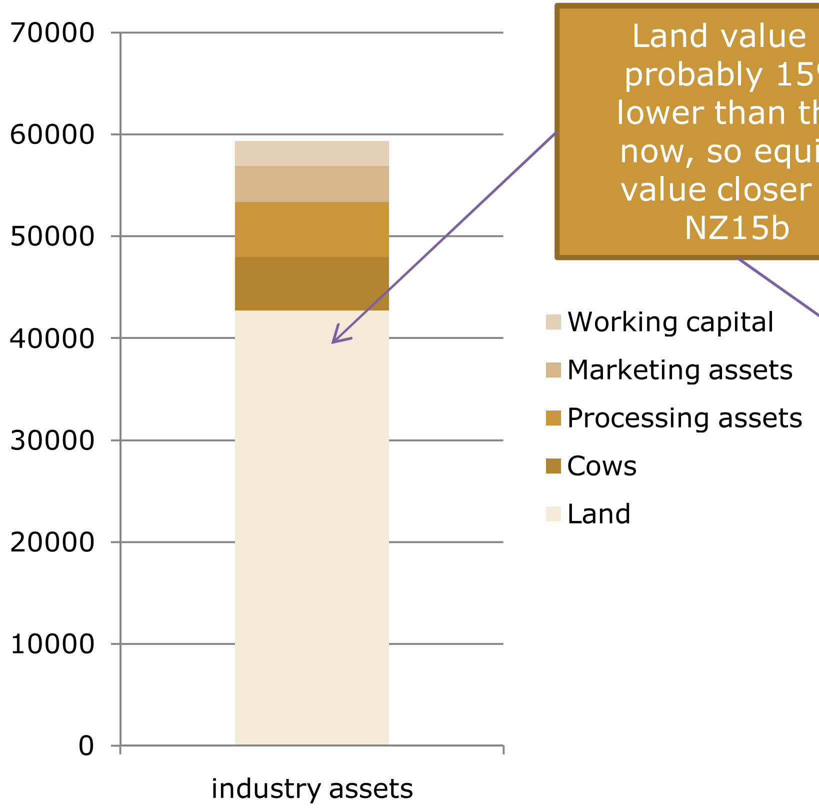
Processors and others - low risk long term assets of 13b

- 85% is Fonterra
- Big improvements in working capital, volumes up 35% in 10 years working capital down by 500m to 3b



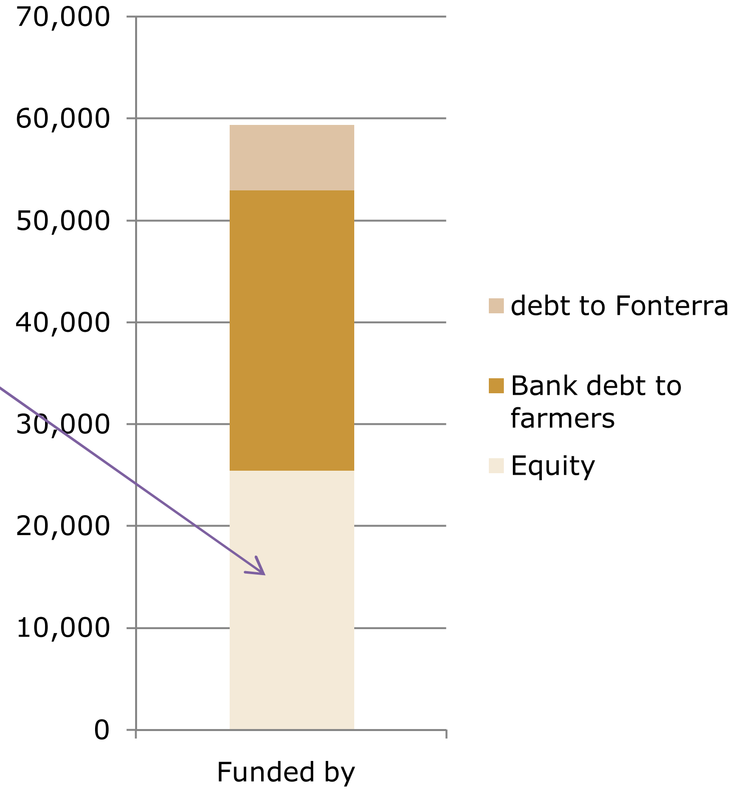
How is the sector funded…2009; is there too much debt?

F owns the bulk of non farm assets
Farm assets represent over 70% of the sector (assumes land value of $30,000 per Ha)

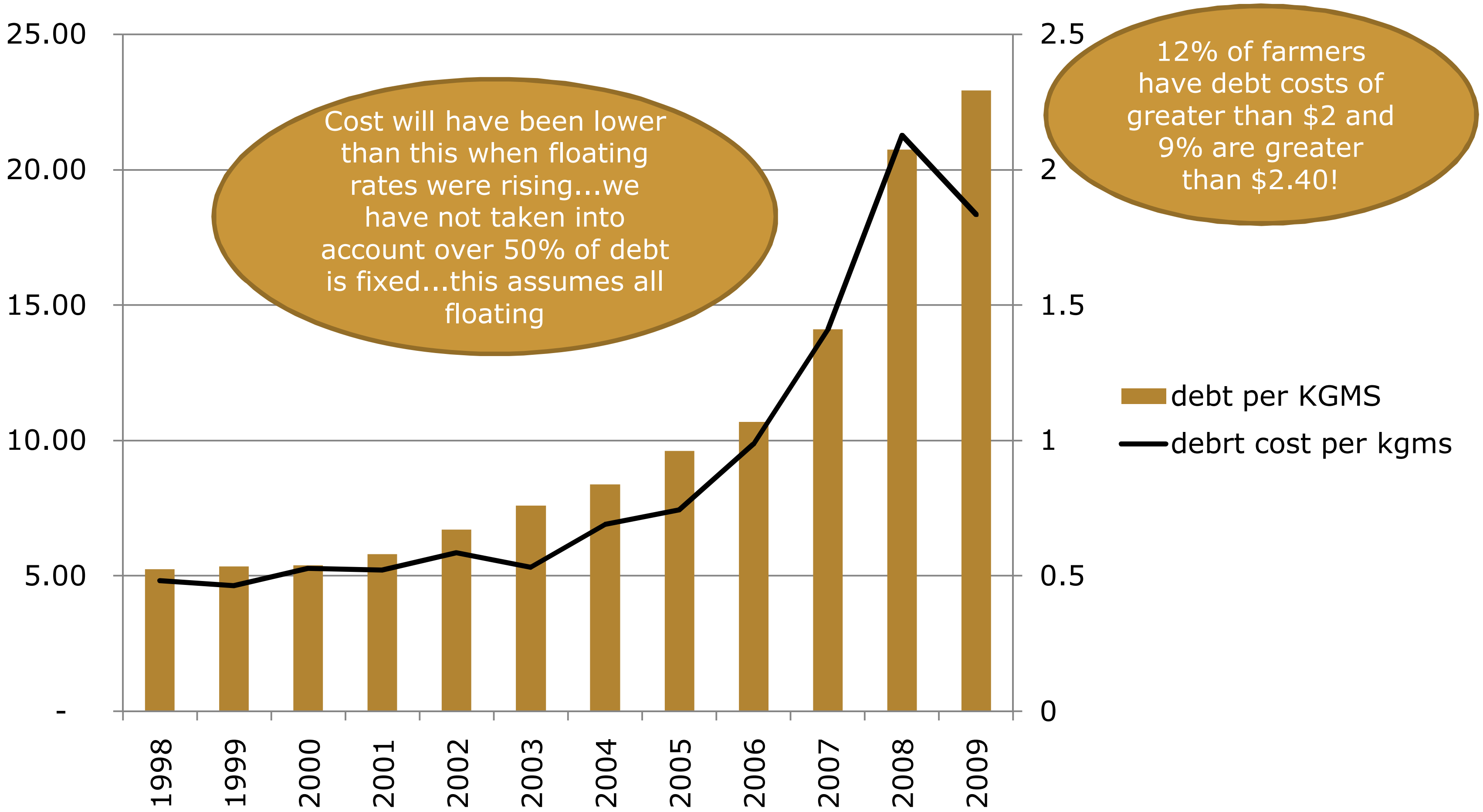


Land value is probably 15% lower than this now, so equity value closer to NZ15b

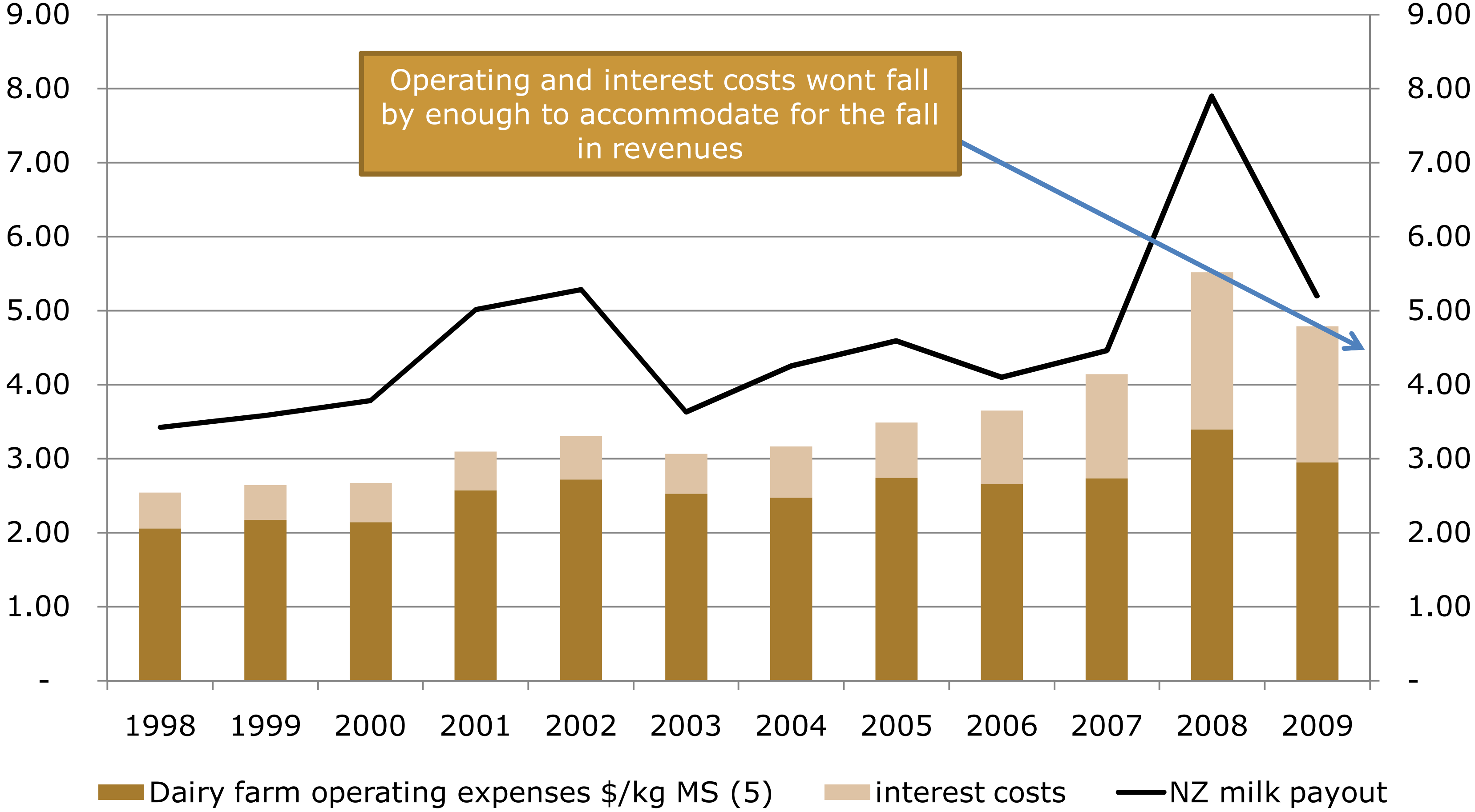
Total debt is 33b… most of that lent directly to farmers but the F debt is effectively guaranteed by F farmer shareholders



On farm AVERAGE debt has grown to $22 per KGMS and cost of debt is just below $2



Interest costs now difficult to service…2010 payout down to $4.50….Average NPAT going negative!



So where is breakeven milk price…about NZ $4.50?

Based on the current capital structure of the sector the point at which interest and EBIT (an interest coverage ratio of 1) are matched is about $NZ4000 per tonne of WMP.

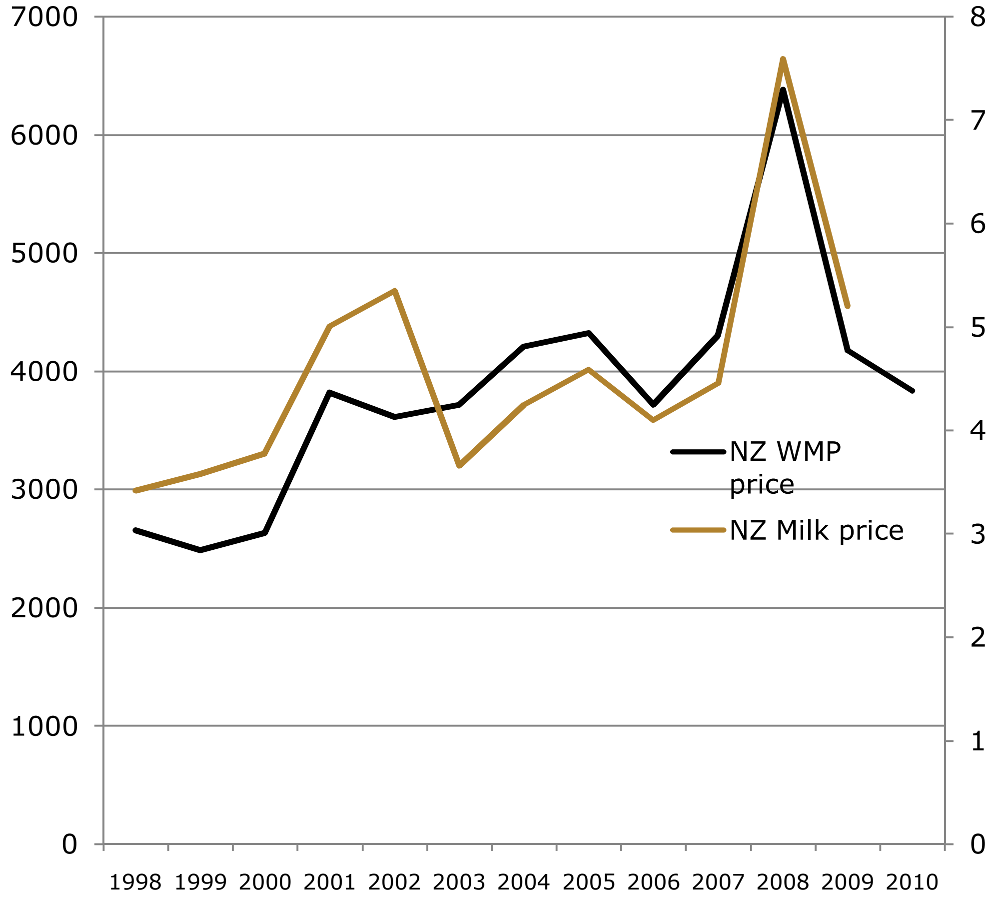
This is approximately NZ$4.50 per KGMS.

AVERAGE EBIT Returns per KGMS down to $1.50 in 2010

Interest costs above $1.50 ON AVERAGE

Intensive high costs farming systems with high debt are in trouble

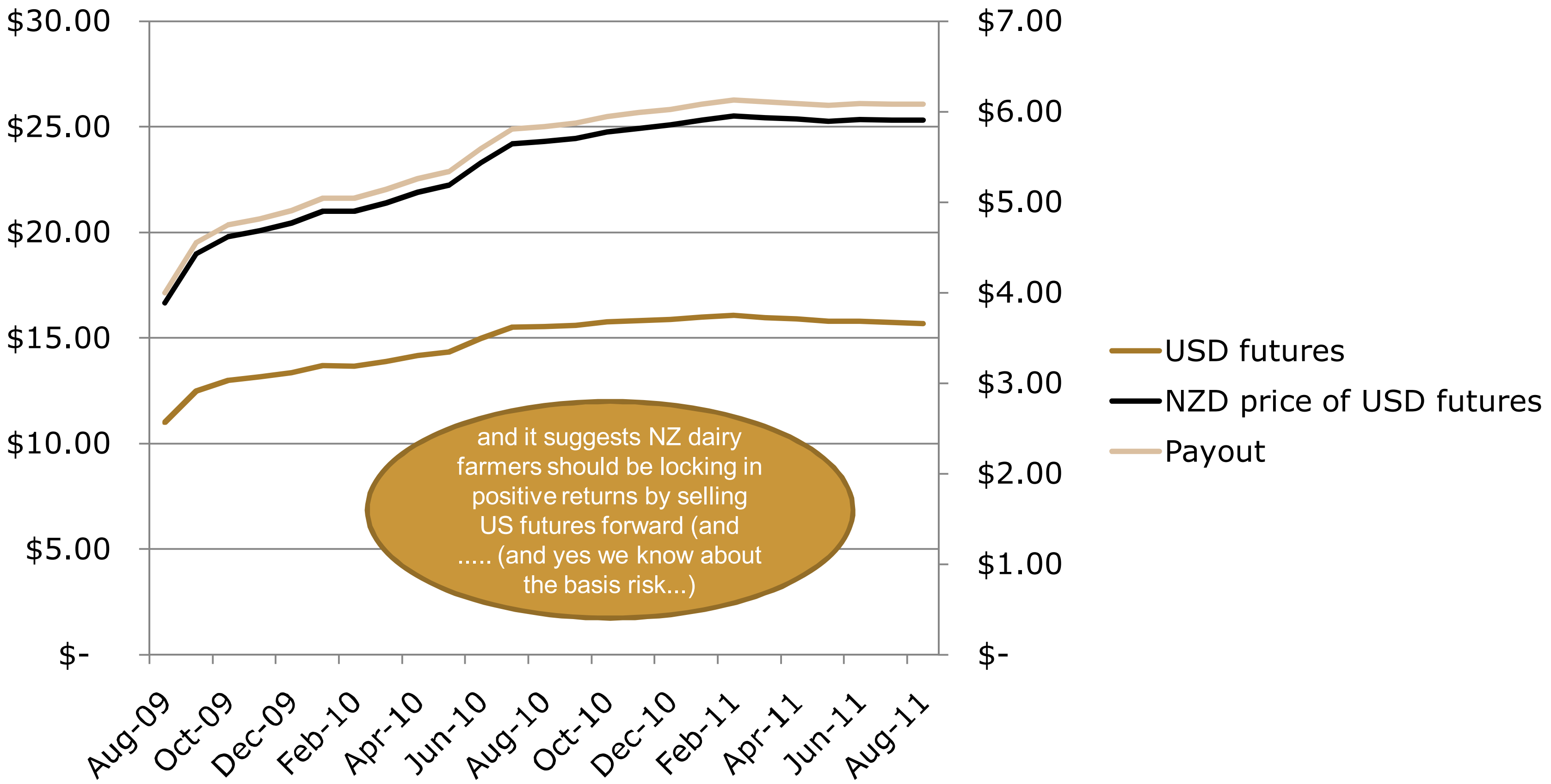
- Cant
- North Otago
- Cent Nth Island



So where is the milk price going?

- Fonterra is forecasting $5.20 for the year just finished (Aug 2009)
- Fonterra is forecasting $4.55 for the 2010 year
- Spot returns were BELOW $4 in July and now up towards $4.55....BUT:
  - All observable milk price markets have positive forward prices
  - Current USD milk prices make a large part of the milk producing world unprofitable
  - US; worst ever condition...killing cows + subsidies
  - Europe; subsidies!!!
  - NZ is unprofitable
- Conclusion = it wont go lower? NZ $4 is the floor

The futures curve for US milk implies a rise of 50% in the next 12 months…overlay that on NZ fwd FX pricing (using a spot of 65c) and it suggests a payout of back towards $6 for the 2011 year



Where will new capital come from?....
Not from the traditional sources

Where has it come from

- Retained earnings
- Bank
- Large shareholders
- Private equity syndicates

Can it carry on?

- No; profitability is zip
- No; bank exposure is too large
  - New capital adequacy
  - Offshore banks reduce exposure
- No...the top ten shareholders all look more likely to sell rather than increase investment:
  - Govt (Transpower, Corrections Dept, SOE's)
  - Alan Hubbard/SCF
  - Graeme Hart
  - Crafers
- No...private syndicates will suffer from illiquidity and poor returns within existing structures

Lets value a dairy farm
(what would we pay for all the farms in NZ)

- Farm value is “ fair” at approx 35B (currently 42B)
  - The equivalent of $24,000 per Ha
  - Suggests current average values of $30,000 have another 15 - 20% to fall...
  - **Remember debt = NZ$19,000 per Ha**
- But very sensitive to EBIT per Ha...see over (and remember the forward milk price)

EBIT per Ha (USD)	1,000.00	
Farmer WACC		7.5%
growth rate		2.0%
EV (USD)	$ 18,289.19	
Total Ha's	1,436,549	
EV	$ 26,273,311,002	
NZD/USD		0.65
EV NZD	$ 40,420,478,464	
Less Cow value	$ 5,216,727,100	
EV NZD	$ 35,203,751,364	
NZ EV per Ha	$ 24,506	

Lets value a dairy farm
(what would we pay for all the farms in NZ)

- But very sensitive to future EBIT and currency
- We would argue that if farms could be purchased at EBIT of US$1000 then the probability skew is biased towards the upside
- i.e the floor is about US$750 but there will still be the boom years of above US$2000

	USD EBIT per Ha					
$ 24,505.78	750	1,000	1,250	1,500	1,750	2,000
0.5000	$ 23,802	$ 32,947	$ 42,092	$ 51,236	$ 60,381	$ 69,525
0.5250	$ 22,496	$ 31,205	$ 39,914	$ 48,623	$ 57,333	$ 66,042
0.5500	$ 21,308	$ 29,622	$ 37,935	$ 46,248	$ 54,561	$ 62,875
0.5750	$ 20,224	$ 28,176	$ 36,128	$ 44,079	$ 52,031	$ 59,983
0.6000	$ 19,230	$ 26,851	$ 34,471	$ 42,092	$ 49,712	$ 57,333
0.6250	$ 18,316	$ 25,631	$ 32,947	$ 40,263	$ 47,578	$ 54,894
0.6500	$ 17,471	$ 24,506	$ 31,540	$ 38,574	$ 45,609	$ 52,643
0.6750	$ 16,690	$ 23,464	$ 30,237	$ 37,011	$ 43,785	$ 50,559
0.7000	$ 15,964	$ 22,496	$ 29,028	$ 35,560	$ 42,092	$ 48,623

Where is the industry going?

Entry to farming and processing market harder

- DIRA
- Higher risk = higher cost of capital
- Higher cost and lower volume of debt

Deleveraging of NZ farmers:

Too much debt on farm and in Fonterra

- Bank debt capital will be higher margin and require reduced leverage
- Lower than expected milk volumes will result in F share redemptions
- F suppliers will accept a change in capital structure of F...release capital (see over)
- F "core business" likely to be a co - op processor and marketer of commodity/ingredient products

Conclusion....Maybe the industry gets lucky and the NZD falls (SOON) but the SHORT TERM outlook for the NZ Dairy sector is poor – it is a tale of deleveraging

- On farm profitability crunch here now but will get worse for some in 2010
  - Two different farms types in NZ, the traditional pasture based system and the higher cost intensive farming systems (e.g Canterbury)
  - Most of the volume growth in the last 5 years has been from the intensive farming systems but the farm working expenses are too high for the 2010 milk price – unfortunately it these farms that have the most debt, we think these farms will fall another 20% and for many that will be negative equity (about 10% of the sector)
- Approx 33 billion of debt with EBIT for industry falling below interest costs at about $4.50 per KGMS
- Cost structures can fall but much more so for the pastoral based owner operator farms (the sweet spot will be the 600 cow herd in Waikato/Taranaki, their costs can get down to $2.50 per KGMS)
- The reduction in costs may reduce NZ milk production by more than is expected
- Companies downstream from farmers will underperform...PGW, AFL, Ravensdown
- The forward milk price looks positive but the time to ruin is short for some farmers....those with high cost systems and high debt costs
- Profitability will be restored for the off farm assets, this will help to recapitalise the sector (the offshore and domestic consumer will pay)

Conclusion....However the medium term outlook remains good

- Yes the world is short of protein and NZ still produces surplus protein very cheaply
  - Pastoral base farming systems will get costs down to $2.50 and at a NZD-USD rate of 50c this would make NZ the low cost dairy producer again
- The major milk producing nations are all losing money in their milk industries....supply will fall
- The current NZ$ value of forward milk prices is above $NZ5
- The need for the NZ industry to de leverage will create an environment for transformational change within Fonterra (why have your lazy equity employed up in Fonterra when you are being forced to sell to sell one of your farms)
- Profitability will be restored in the off farm (up stream) assets of the sector, this will help to recapitalise the sector (the offshore and domestic consumer will pay)
  - Fonterra value add
  - Mainland, Anchor
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  - Kapiti, Kaimai, Puhoi...
- The NZ industry is low risk...too big to fail, relies on FX earnings with an effective floating rate currency

DIFL - Contact Dairy Investments - Windows Internet Explorer

http://www.difl.co.nz/contact-dairy-investment-fund.php

DAIRY INVESTMENT
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BANK ACCOUNT DETAILS
Bank Name: Bank of New Zealand
Bank Branch: Manners Street, Wellington
Account name: Dairy Investment Fund Limited
Account Number: 02-0568-0019900-00

Please use the form below to ask Geoff & Nigel a question and we will email you with an answer.
All fields are required.

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Tuesday
25 August

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