

Life is like a box of chocolates

- Dairy prices firmed at the auction overnight, beating expectations.
- Meanwhile, Fonterra’s half-year profit results were a touch softer than expectations.
- On balance, the combined results see us retain our positive dairy sector outlook.

Summary

According to Forrest Gump, “life is like a box of chocolates – you never know what you’re gonna get.” And it seems today, this analogy applies to the dairy sector.

First up, **dairy prices lifted surprisingly overnight**. Indeed, the combination of lower prices and Argentinian floods have tempted additional Latin American buyers back on to the GlobalDairyTrade platform. Moreover, this was a source of demand that the dairy futures market pricing had not factored in.

In contrast, **Fonterra’s 2017 Interim Results were on the soft side of expectations**. For example, Fonterra trimmed five cents off its 2016/17 forecast earnings per share, to 45 to 55 cents.

But Fonterra, too, managed a surprise. That is, **despite the lower forecast earnings, Fonterra indicated a cash dividend (40 cents) at the upper end of its previously indicated range**. While some farmers may welcome the higher cash payout (especially following the dairy downturn), we wonder if this is potentially a case of robbing Peter to pay Paul.

All up though, we maintain our positive dairy sector outlook. In particular, we agree with Fonterra’s 2016/17 milk price forecast of \$6.00/kg, and we also reaffirm our 2017/18 milk price forecast of \$6.75/kg.

Fonterra 2017 Interim Results

Fonterra’s interim results were a mixed bag. On the surface, the reconfirmed 2016/17 milk price forecast of \$6.00/kg and forecast cash payout (i.e. milk price plus cash dividend) of \$6.40/kg make for good reading. Indeed in the aftermath of the dairy downturn, the announcement of the 20 cent interim dividend payment in April will certainly boost farm cashflows, and to a degree, confidence levels.

However, scratch beneath the surface and there are pockets of concern. Firstly, the normalised EBIT was 9% lower than at the same period last year. Moreover, Fonterra trimmed the forecast earnings per share for the 2016/17 year by five cents to 45 to 55 cents.

This makes the announcement of the 40 cent cash dividend forecast seem a touch optimistic. In other words, Fonterra expects profits to be lower than previously thought, but that its balance sheet is strong enough to allow a higher dividend payment to farmers. For our part, we aren’t convinced, but in the context of a much improved milk price this concern may not be material.

21 March auction comments

Dairy prices firmed overnight. Whole milk powder (WMP; up 2.9%) and milk fats (Anhydrous Milk Fat up 3.0%; butter up 4.9%) led prices higher. Overall auction prices lifted 1.7%. The auction result also beat expectations. For example, WMP futures pricing had indicated a fall in the 4% to 6% range. Moreover, the result partially reverses the weak result from the previous auction where WMP prices had fallen 12.4%.

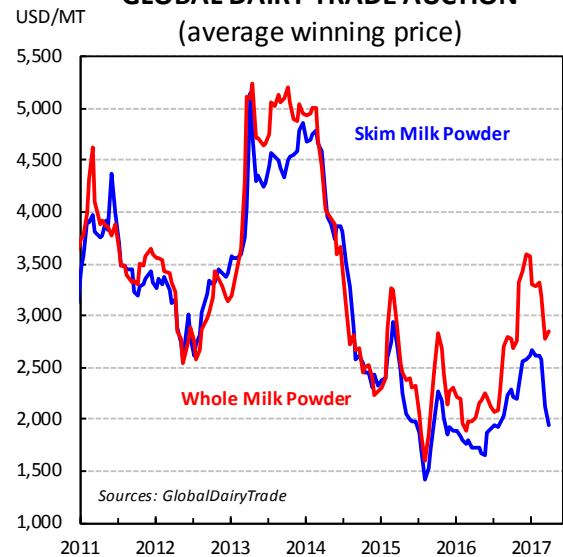
Season-end Forecasts

| | 2016/17 | | 2017/18 | Long Run |
|-------------|----------|--------|---------|---------------|
| | Fonterra | ASB | ASB | ASB |
| Milk Price* | \$6.00 | \$6.00 | \$6.75 | \$6.50-\$7.00 |

* per kg of milk solids (excluding dividend).

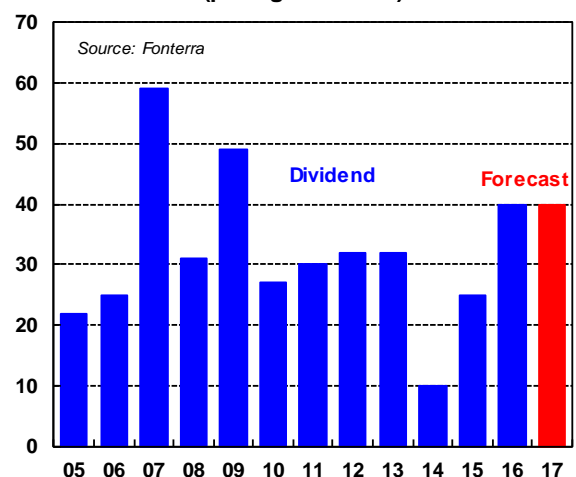
Key Auction Results

GLOBAL DAIRY TRADE AUCTION



Fonterra 2017 Interim Results

FONTERRA CASH DIVIDENDS (per kg milksolid)



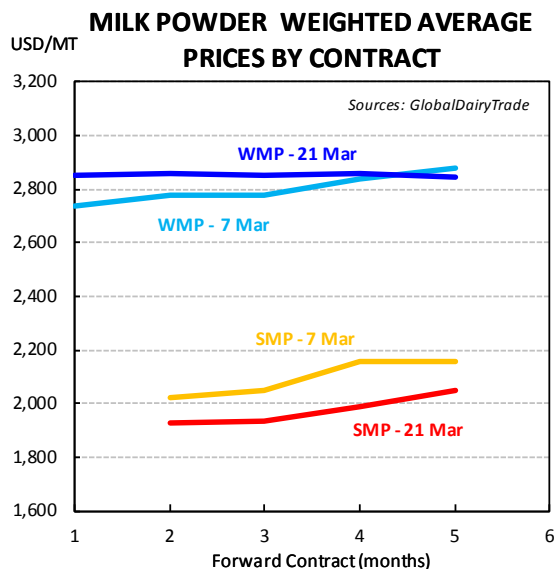
Some of the surprise may be due to Latin America buyers entering the market. These buyers may be seeking alternatives to Argentinian product (Argentina is a major WMP exporter), with dairy production there still weak following floods.

Meanwhile, skim milk powder (SMP) prices bucked the overall trend, falling 10.1%. In this respect, strong US production and the early stages of an EU production recovery (along with still high stocks) are combining to put downward pressure on SMP prices.

Over the remainder of this season, **we expect prices to largely track sideways.** However, heading into next season and as the late season NZ production fillip clears dairy markets, we expect WMP prices to remain well-supported.

Implications

All up, we maintain our positive dairy sector outlook. Specifically, the auction result firms up our 2016/17 and 2017/18 milk price forecasts of \$6.00/kg and \$6.75/kg, respectively.



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