

Rural Economic Note

2017/18 Fonterra Annual Results

13 September 2018

Milk price, but still no cream

- Fonterra has posted its first ever annual loss.
- While the Danone and Beingmate writedowns were large and grabbed headlines, the underlying business performance also deteriorated.
- Meanwhile, Fonterra reaffirmed its 2018/19 farmgate milk price forecast at \$6.75/kg.

Summary

Fonterra's financial struggles have continued over 2017/18. This financial year it posted its first ever loss of \$196m.

While the Danone and Beingmate writedowns grab headlines, we are more concerned with the trend in underlying performance. For example, Fonterra's Normalised EBIT has fallen for two consecutive years, and is down by around a third over the period.

Moreover, a worrying pattern has developed. That is, Fonterra starts the year bullishly with its forecasts, but then fails to deliver financial results that match its plans. Even in the years where the milk price is low, profits and dividends have been modest at best.

Meanwhile, the milk price continues to be the silver lining on otherwise weak performance. Last year's \$6.69/kg figure was a step up from a year ago and we, like Fonterra, are positive about the year ahead. But is it enough? We think farmers should be able to have their (milk price) cake and dividend too.

Annual Results

Fonterra has announced weak financial results for the 2017/18 financial year, highlighted by a \$196m net loss after tax. Earnings per share were reported at 24 cents, down 22 cents from 2016/17.

Looking at the profit numbers, normalised EBIT fell 22% from 2017/18 to \$902m. EBIT has now fallen for two years in a row, with Fonterra's underlying profitability falling a around a third (\$456m) over this period. Fonterra's return on capital also fell to 6.3%, compared to 8.3% last year.

2017/18 Financial results

	2017/18	2016/17	Change
Revenue	\$20.4bn	\$19.2bn	+6%
Normalised EBIT	\$0.9 bn	\$1.155 bn	-22%
Net profit/loss after tax	-\$196m	\$745m	-126%
Return on capital	6.3%	8.3%	-2.0 pts
Debt	\$6.1bn	\$5.4bn	+13%
Gearing ratio	48.4%	44.3%	+4.1 pts
Earnings per share	\$0.24	\$0.46	-48%
Cash payout (per kg MS)	\$6.79	\$6.52	+4%
Farmgate milk price	\$6.69	\$6.12	+9%
Cash dividend per share	\$0.10	\$0.40	-75%

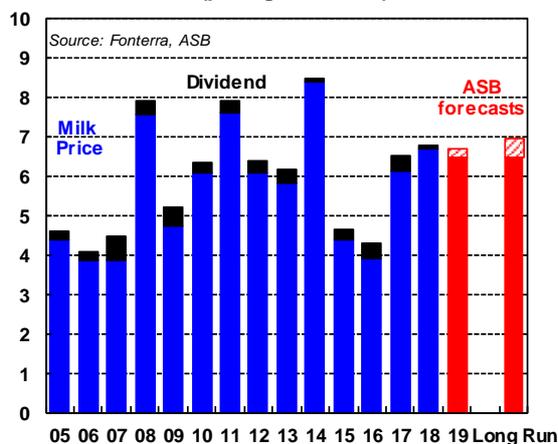
Notably, **the weak results included the previously reported \$232 million payment to Danone relating to the arbitration, and \$439 million write down on Fonterra's Beingmate investment.** Fonterra also noted that tight margins, the higher than expected milk price, increases in operating expenses and higher than expected butter prices

added further weakness to the results.

While Fonterra’s results were down on 2016/17, the cash payout for farmers was up on last year. All up and with the milk price finalised at \$6.69/kg, the cash payout settled at \$6.79/kg; this was \$0.27 higher than the 2016/17 cash payout of \$6.52/kg.

That said, Fonterra’s balance sheet has also weakened. Debt was up \$0.7 billion to \$6.1 billion, while Fonterra’s gearing ratio rose 4.1 percentage points to 48.4%. With this in mind, it was not surprising that Fonterra withheld the second dividend payment and paid the artificially low milk price (i.e. below that prescribed by the milk price manual).

MILK PRICE AND DIVIDENDS (per kg milksolid)



Fonterra is hoping for an improved performance over 2018/19. It has signalled an earnings-per-share range of 25 to 35 cents. When combined with the reaffirmed milk price forecast of \$6.75/kg, Fonterra forecasts the cash payout to farmers likely to be \$6.95/kg or above.

Implications

For us, Fonterra continues to underperform financially.

Moreover, it has developed a pattern of over-promising and under-delivering in financial terms. In particular, when looking at the business’s underlying performance (normalised EBIT), Fonterra has struggled to put financial runs on the board. And that observation holds in both all milk price environments, including high and low.

Season end farmgate milk price forecasts

	2017/18	2018/19		Long Run
	Final	Fonterra	ASB	ASB
Milk Price*	\$6.69	\$6.75	\$6.50	\$6.50-\$7.00

* per kg of milk solids (excluding dividend).

On the farmgate milk price side, we are more confident - we continue to forecast a 2017/18 milk price of \$6.50/kg, modestly lower than Fonterra’s forecast of \$6.75/kg. However, we think farmers should expect a healthy dividend on top of this. Indeed, farmers should be able to have their milk price cake and dividend too.

Finally, as a major player in the New Zealand economy, Fonterra’s ongoing underperformance has been disappointing.

Better performance can make a significant difference to the broader performance of the New Zealand economy.

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