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Dairy and Products

Fonterra Update

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Report Highlights:

Fonterra announces first year loss of US\$ 24 million. Fonterra revises payout forecast for 2002-03 down to US\$ 1.78/kg milksolids.

Includes PSD changes: No
Includes Trade Matrix: No
Unscheduled Report
Wellington [NZ1], NZ

Fonterra announces NZ\$ 50 million first year loss

According to Dairy Farmers of New Zealand, Fonterra's reported loss of NZ\$ 50 million (US\$ 24 million) for its first financial year since the merger of the NZ dairy industry occurred because Fonterra is paying out money that farmers have not earned. Fonterra indicated that last season's payout of NZ\$ 5.30 (US\$ 2.54) per kg milksolids has been under pressure due to falling commodity prices, but it decided to take the loss rather than reduce the payout retrospectively. This means that the average-sized dairy operation will be overpaid by about NZ\$ 3,000 (US\$ 1,440). Farmers supplied 90 percent more milk during May than expected, which was fostered by good climatic conditions. However, the additional milk was worth only NZ\$ 3.50 (US\$ 1.68) per kg milksolids according to Fonterra (versus earlier forecasts of NZ\$ 4 or US\$ 1.92 for the 2002-03 season). While Fonterra could have revised this season's payout down to NZ\$ 5.28 (US\$ 2.53) per kg milksolids it decided against doing so as it considered the loss immaterial relative to its NZ\$ 4.4 billion (US\$ 2.11 billion) in equity and NZ\$ 13.9 billion (US\$ 6.67 billion) turnover.

Fonterra revises 2002/2003 payout forecast down to NZ\$ 3.70 (US\$ 1.78) per kg milksolids

Fonterra is, however, revising its payout forecast for 2002-03 further down. The company announced that its forecast of NZ\$ 4 (US\$ 1.92) kg milksolids two months ago relied on a recovery in commodity prices near the end of this year. These are now threatened to be further reduced as restitution payments to subsidize dairy exports have been increased again by the European Commission (dairy commodity prices had effectively halved over the past 12 month), and an exchange rate of NZ\$ 2.22 per 1 US\$. However, the higher long term exchange rate is now forecast by many economists at approximately NZ\$ 2 per 1 US\$.

The payout cut follows an earlier cut in May which saw the payout forecast reduced from NZ\$ 4.50 (US\$ 2.16) to NZ\$ 4 (US\$ 1.92) per kg milksolids. Dairy Farmers of New Zealand is not pleased with this announcement and claims that Fonterra could have made this announcement earlier, giving farmers more time to revise their budgets for the coming season. Dairy Farmers of New Zealand is also concerned that the final payout may be closer to NZ\$ 3.30 (US\$ 1.58) once Fonterra's merger costs and levies are deducted. The payout reduction will reduce total payout by about NZ\$ 334 million (US\$ 160.3 million) reducing dairy farmers incomes by an average NZ\$ 40,000 (US\$ 19,200).

Fonterra's performance according to Standard & Poor's commodity milk price

Fonterra has released financial information based on its "new economics", which allows its performance to be analyzed more transparently than under the industry's old arrangements. Of the NZ\$ 5.33 (US\$ 2.56) per kg milksolids final payout (less NZ 3 cents or US 1.4 cents for industry good activities) the Actual Milk Return (AMR) is NZ\$ 5.08 (US\$ 2.44). Returns from value added activities were worth NZ 49 cents (US 23.5 cents), less 21 cents (US 10.1 cents) from foreign exchange hedging and 8 cents (US 3.8 cents) from Fair Value adjustments. For 2002-03 the AMR is forecast to be NZ\$ 3.19 (US\$ 1.53) while 66 cents (US 31.7 cents) would be the return from value added activities (mainly quota markets), plus 7 cents (US 3.4 cents) from foreign exchange hedging and 8 cents (US 3.8 cents) from Fair Value adjustments.

The second measure to determine Fonterra's performance is based on the Commodity Milk Price (CMP), which is a theoretical measure of what an efficient commodity producer could pay for

milk and still make an adequate return on capital. Standard & Poor has developed a model to calculate the CMP. For the 2001-02 season the CMP is NZ\$ 5.48 (US\$ 2.63), creating a 40 cents (US 19.2) gap above Fonterra's AMR, which was caused by Fonterra's product-mix differing from Standard & Poor's optimal mix, slightly higher than optimal manufacturing, and slightly poorer than optimal capital utilization and the tax implications of that. For 2002-03 the CMP is forecast at NZ\$ 4.17 (US\$ 2), while Fonterra, using more conservative assumptions, predicts a CMP of NZ\$ 3.52 (US\$ 1.69), which suggests a gap between the CMP and AMR of 33 cents (US 15.8 cents). While this figure indicates a smaller actual gap, it shows that the gap has grown in percentage terms from 7.2 percent to 9.3 percent, possibly indicating decreasing performance relative to the hypothetically efficient commodity producer. (Given Fonterra's recent announcement of lower payout expectations for 2002-03 the new CMP and AMR will be reported as soon as they become available).

Conclusion

Given that Fonterra has just passed its first full year in operation after the industry merger last year, many observers and industry insiders are keeping a keen eye on Fonterra's future performance after the record payout for the last season. In a recent Dairy Farmers of New Zealand AGM, concerns were voiced over the transparency of the company's activities, the risks associated with its overseas investment strategy, and the flow of information between farmer shareholders and the company. In addition, the two independent NZ dairy companies, Tatua and Westland, which process about 2.5 percent of the country's milk, have had payouts of NZ\$ 6.77 (US\$ 3.25) and NZ\$ 5.43 (US\$ 2.61) for 2001-02, respectively, while also expecting higher payouts of NZ\$ 3.80 - 4 (US\$ 1.82 - 1.92) for the 2002-03 season. Fonterra's latest payout forecast is likely to be viewed not only in relation to those payouts but also in relation to the potential synergy gains farmer shareholders were made to expect from last year's merger, and Fonterra's ambition to be a global dairy company.