Market Announcement

6 December 2018

FONTERRA REVISES FORECAST FARMGATE MILK PRICE AND PROVIDES Q1 UPDATE

- Forecast Farmgate Milk Price range: $6.00 - $6.30 per kgMS
- Forecast earnings per share range: 25-35 cents
- Forecast New Zealand milk collections: 1,550 million kgMS, up 3%
- Sales volumes: 3.6 billion LME, down 6%
- Revenue: $3.8 billion, down 4%
- Gross margin: $646 million, down $14 million
- Gross margin percentage: 17%, up from 16.6%
- Operating expenses: $656 million, up 3%
- Capital expenditure: $188 million, up $42 million

Fonterra Co-operative Group Limited today revised its 2018/19 forecast Farmgate Milk Price range from $6.25-$6.50 per kgMS to $6.00-$6.30 per kgMS and shared an update on its first quarter business performance.

Fonterra Chairman John Monaghan says the revision in the forecast Farmgate Milk Price range is due to the global milk supply remaining stronger relative to demand, which has driven a downward trend on the GlobalDairyTrade (GDT) index since May.

“Since our October milk price update, production from Europe has flattened off the back of dry weather and rising feed costs. US milk volumes are still forecast to be up one per cent for the year,” says Mr Monaghan.

“Here in New Zealand, we are maintaining our forecast collections at 1,550 million kgMS. NIWA is saying its likely we will see an abnormal El Nino weather pattern over summer and this could impact our farmers’ milk production.

“Demand from China and Asia remains strong. However, we are seeing geopolitical disruption impacting demand from countries that traditionally buy a lot of fat products from us.

“Today’s forecast range assumes dairy prices will firm across the balance of the season. This is consistent with the views of other market commentators.

“There are still a number of unknowns in the global demand and supply picture and we recommend farmers budget with ongoing caution. Fonterra’s Advance Rate has been set off a milk price of $6.15 per kgMS.”

First quarter business update

Fonterra’s first quarter gross margin of $646 million is down $14 million compared to the same period last year and up slightly on a percentage basis from 16.6 per cent to 17 per cent. Revenue of $3.8 billion, is down four per cent and sales volumes were down six per cent to 3.6 billion liquid milk equivalent (LME).

The Co-op's Ingredients business, despite lower sales volumes, performed solidly during Q1 with a gross margin of $273 million, up $28 million on last year. The Consumer business also performed well with a gross margin of $310 million, up $10 million on last year, and volumes were up five per cent.

Chief Executive Miles Hurrell says the Co-op generally makes a smaller proportion of its total annual sales in the first quarter due to the seasonal nature of our milk supply.

"This means the results from Q1 do not give much insight into the Co-op's expected earnings performance for the full year. It does, however, put the spotlight on where we have challenges that we need to address," says Mr Hurrell.

"In particular, we are seeing challenges in our Australian Ingredients, Greater China Foodservice and Asia Foodservice businesses. I want to be clear with our farmers and unit holders about how we are tackling these issues.

"In our Australian Ingredients business, we have lower milk collections as a result of drought conditions and increased competition for milk supply. We are responding by focusing on the performance levers in our control – the main one being reducing our operating expenses to reflect lower milk collections.

"The lower gross margins and sales volumes in Greater China Foodservice and Asia Foodservice in Q1 are mainly due to the high sales volumes of butter and cream cheese at the end of Q4 2018, a slightly slower start to sales of UHT culinary cream and more sales of UHT milk which has a lower margin relative to our other products. We are expecting our sales to lift as we are seeing strong sales from our distributors off the back of demand in China for New Zealand made products, particularly our UHT culinary creams. We are also prioritising value and moving away from lower margin contracts."

Portfolio review

Commenting on the Board led portfolio review Mr Monaghan says there is a lot of action and progress but it will take time to flow through into financial results.

"We have reached an agreement in principle with Beingmate that will see us return to full ownership of the Darnum plant by 31 December 2018 and enter into a multi-year agreement for Beingmate to purchase ingredients from us.

"We are also looking at our ongoing ownership of Tip Top and have appointed FNZC as our external advisor to work with us as we consider a range of options. We want to see Tip Top remain a New Zealand based business and this is being factored into our options.

"While performing well, Tip Top is our only ice cream business and has reached maturity as an investment for us. To take it to its next phase successfully will require a level of investment beyond what we are willing to make.

"We are still some months off from completing the full portfolio review of assets, investments and partnerships. We are moving quickly to meet our commitment to reducing our debt levels by $800 million by the end of the financial year. This requires both improved performance from last year and the divestment of assets."

Lifting performance

In respect to the three-point plan to lift the Co-op's performance, Mr Hurrell says progress is being made on fixing the businesses that are not performing.

"Fonterra Brands New Zealand is one of the businesses that is starting to turn around. It's early days but overall our Consumer and Foodservice business in Oceania delivered higher sales volumes and margins for Q1 compared the same period last year. A significant contributor of this is the improved operational performance in New Zealand.

"We have set our capital expenditure (CAPEX) limit at $650 million. While we are ahead on the same time last year, this was planned as we completed the final stages of projects from last year. Once these assets are delivered, our focus will turn to ensuring they hit their Return on Capital targets.

"We remain committed to returning our operating expenses (OPEX) to FY17 levels – however, they were up three per cent for the first quarter compared to the same period last year. The majority of these costs were committed to before I set our new OPEX target. They relate to higher advertising and promotion and storage costs in our Consumer and Foodservice business, additional costs since taking the management of Anmum back from Beingmate and higher storage and distribution costs for Ingredients as we collected and moved more milk than we budgeted for."

Outlook for 2019

Mr Hurrell says the Co-op is maintaining its forecast earnings per share range of 25-35 cents.

"Q1 gross margin percentage was up on last year and we have identified the challenges that need addressing. Our earnings forecast for the remainder of the year is based on a milk price within the $6.00-$6.30 per kgMS range and, on this basis, we are confident in our earnings guidance."

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About Fonterra

We're a global dairy nutrition company owned by 10,000 farmers and their families. We've built our expertise on the legacy of the thousands of farmers who've made New Zealand a world leader in dairy. With a can-do attitude and a collaborative spirit, we're a world leading dairy exporter. Our 22,000 people share the goodness of dairy nutrition with the world through our innovative consumer, foodservice and ingredient solutions brands, and our farming and processing operations across four continents.