Market Announcement

21 March 2018

FONTERRA ANNOUNCES 2018 INTERIM RESULTS

Results Highlights

- Forecast Farmgate Milk Price $6.55 per kgMS
- Interim dividend of 10 cents per share – to be paid in April
- Full year forecast dividend range 25 – 35 cents per share
- Total forecast cash payout $6.80 - $6.90
- Revenue $9.8 billion, up 6% from the 2017 interim results
- Normalised EBIT $458 million*, down 25% from the 2017 interim results
- Beingmate investment impairment $405 million
- Normalised Net profit after tax (NPAT) $248 million*, down 36% from the 2017 interim results
- NPAT $348 million loss, down 183% from the 2017 interim results
- Normalised interim earnings per share 15 cents*
- Ingredients normalised EBIT $558 million*, up 9% from the 2017 interim results
- Consumer and Foodservice normalised EBIT $193 million*, down 38% from the 2017 interim results

** Non-GAAP measures. Information on the non-GAAP financial information used by Fonterra are found at the end of this document.*

Forecast cash payout

Fonterra Co-operative Group Limited today increased its forecast Farmgate Milk Price for the 2017/18 season to $6.55 per kgMS and announced a full year forecast dividend range of 25 - 35 cents per share with an interim dividend of 10 cents per share.

Chairman John Wilson says the ongoing strong global demand for dairy and stable global supply are continuing to support global prices, particularly for the important Whole Milk Powder category.

“Farmers will welcome a forecast cash payout of $6.80 - $6.90, which would be the third highest in the last decade. This is also good news for New Zealand as it represents around $10 billion flowing into the country’s economy. However, we are very aware of the challenges many of our farmers are facing this season with difficult weather conditions impacting production.

“While the global supply and demand picture remains positive and we expect prices to stay around current levels, we will be watching for any impact on market sentiment as spring production volumes build in Europe,” he added.

Fonterra’s Greater China business continues to perform well overall but the Co-operative has re-assessed the value of its Beingmate investment so that it reflects a fair value at this point in time.

Commenting on this decision, Mr Wilson says the Board has assessed the carrying value of Beingmate at $244 million and therefore taken an impairment of $405 million.

“While we appreciate the substantial opportunity and privilege of our business in China, our shareholders and unitholders will be rightfully disappointed with this outcome. Beingmate’s continued under-performance is unacceptable. The turnaround of the investment is a key priority for our senior management team.”

“The opportunity in the Chinese infant formula market remains, as does the potential for our Beingmate partnership – but an immediate business transformation is needed for Beingmate to benefit from the ongoing changes in the market.”

In December, Fonterra paid $183 million to Danone following the conclusion of an arbitration that arose from the WPC80 precautionary recall in 2013.

Mr Wilson says the Board will decide how the Beingmate impairment and the Danone payment will be treated for final dividend purposes after the end of the financial year when it will have the full picture of Fonterra’s operating performance. Given the possible impact of these decisions, the Board is providing a forecast dividend range for the full-year of 25 – 35 cents per share, rather than just the earnings per share guidance normally given.

“Based on our dividend policy, this forecast dividend range would allow for the Board to add back the Beingmate impairment at the lower end through to an adjustment for both Beingmate and Danone as one-off events at the higher end.

“In the circumstances, we have taken a prudent approach in determining the 10 cent interim dividend.”

Our Business Performance

Chief Executive Theo Spierings says the operating performance for the first half year was generally as expected.

“We knew going into this year we would have to carefully manage low starting inventory levels. This was followed by reduced New Zealand milk collections due to difficult weather conditions, further impacting our volumes available for sale.

“On top of this, we also had to navigate higher input costs which squeezed our margins.

“So, at the end of the first half, our total sales volumes are down 11 per cent to 10.5 billion LME, and normalised earnings before interest and tax (EBIT) 25 per cent lower at $458 million* compared to $607 million in the same period last year,” says Mr Spierings.

“Despite this, overall sales revenue in the business was up six per cent to $9.8 billion compared to the same period last year, mainly due to the improved global prices for dairy.

“While our reported net profit after tax (NPAT) shows a loss of $348 million, it includes the payment to Danone and the Beingmate impairment. As these are one-off events, our normalised Net Profit After Tax of $248 million* is a better reflection of our underlying operating performance for the half year.”

Commenting on the Ingredients business Mr Spierings says the team achieved a strong result with normalised EBIT growth of nine per cent to $558 million* compared to $510 million* in the same period last year, despite lower sales volumes of 9.8 billion LME.

“The result benefited from higher stream returns in the first half – $90 million compared to $40 million for the same period last year. These additional stream returns were predominantly due to improved margins for non-reference products during this period.

In relation to Fonterra’s Consumer and Foodservice business, Mr Spierings says the higher input costs meant margins were reduced by 15 per cent over the period, with strong competition in the

Co-operative's strategic markets, especially in Foodservice, limiting the short-term options to pass through the higher costs.

"Consumer and Foodservice's volumes were two per cent lower compared to the same period last year. Our sales volumes in Asia, Latin America, and Greater China improved but they were offset by lower volumes in Oceania, caused primarily by operational start-up challenges at our new distribution centre in Auckland, which is now operating as we'd expect.

"Overall, Consumer and Foodservice normalised EBIT was $193 million* compared to an exceptional $313 million* in the prior comparable period when input costs were considerably lower."

Mr Spierings says the Co-operative's China Farms strategy is beginning to bear fruit and the farms' improved performance is reflected a normalised EBIT loss of $12 million* – half the $24 million* loss for the same period last year.

"This result is helped by the price the Ingredients business pays China Farms for its milk, which is currently higher than the unsustainably low domestic milk price. This approach is producing better results by allowing the China Farms managers to focus on ongoing on-farm efficiencies and the Ingredients managers to focus on getting the best price for our high-quality milk.

"The potential is strong as Chinese demand for high-quality local fresh milk continues to grow. In February this year, we launched a new premium 'Daily Fresh' milk range alongside Alibaba's Hema Fresh stores in Shanghai and Suzhou. This milk is sourced directly from our farm hub in Hebei province. While early days, the opportunity for scale and reach alongside Alibaba is huge."

Our Greater China Business

In talking about Fonterra's Greater China business, Mr Spierings says that while the Beingmate investment has underperformed, the Co-operative's integrated Greater China business is delivering positive results for shareholders and unitholders and continues to have high growth prospects.

"In our first half, China volumes accounted for 2.2 billion LME of our total 9.8 billion LME in ingredients, with around 80 per cent of this milk sourced in New Zealand. In our Consumer and Foodservice business, China volumes accounted for 600 million LMEs of the total 2.7 billion LMEs sold over the first half, with Consumer and Foodservice in Greater China achieving normalised EBIT of $92 million* on volume growth of three per cent compared to the same period last year.

"Clearly the outcome of re-assessing the value of our investment in Beingmate downwards is unacceptable to our shareholders and unitholders. The recovery of the value of this investment is the number one immediate priority for me and the senior management team.

"To be blunt, the investment in Beingmate has not gone the way we expected and there are things we would do differently knowing what we know now. We are very focused on doing all we can to get things where they need to be.

"As an 18.8 per cent shareholder, we do not have direct control over the company but we are influencing its direction and continue to call for an urgent business transformation by working co-operatively with Beingmate's founder and majority shareholder. We see there are a number of opportunities to reverse the current performance, unlock the distribution network and meet customers' preferences for e-commerce.

"While this seems like a slow process and we're not allowed to share all of the information about Beingmate's business, we are working hard in the background to get ourselves in a position where there is a tangible action plan for transforming Beingmate that we can share more widely and monitor progress," says Mr Spierings.

A working group of the Board – that includes Independent Directors Simon Israel and Clinton Dines, who both have significant China experience and expertise – is providing guidance and oversight as the senior management team work to recover the investment.

Outlook

Fonterra expects its earnings to be weighted to the second half of the year.

Despite more favourable weather conditions recently, the Co-operative still expects its New Zealand milk volumes to be down for the year and will be managing its inventory and product mix carefully for the remainder of the season to ensure it maximises the overall value of its farmers' milk.

Mr Spierings says a strong commitment to the V3 strategy of shifting more volume into higher value products at velocity is critical to the business achieving its forecast.

"We will continue to put as much milk as possible into higher value products, particularly into our Advanced Ingredients business, and Consumer and Foodservice business where we are still targeting an additional 400 million litres of volume this year.

"Our Co-operative remains focused on delivering sustainable value for our farmers – that's a sustainable Farmgate Milk Price, dividend, and return on their investment in the Co-op as we provide high quality dairy nutrition to consumers around the world."

The record date for the payment of the dividend is 6 April 2018, and the payment date is 20 April 2018. The Co-operative will continue to offer a dividend reinvestment plan, the strike price at which shares are issued incorporating a discount of 2.5%. Eligible shareholders who wish to participate in the dividend reinvestment plan for this dividend need to submit a notice of participation by 6 April 2018.

Click here to view Fonterra's Interim Results presentation and Interim Review.

Non-GAAP financial information

Fonterra uses several non-GAAP measures when discussing financial performance. These measures include normalised segment earnings, normalised EBIT, EBIT, normalisation adjustments, normalised earnings per share, normalised NPAT and payout. These are non-GAAP financial measures and are not defined by NZ IFRS.

Management believes that these measures provide useful information as they provide valuable insight on the underlying performance of the business. They are used internally to evaluate the underlying performance of business units and to analyse trends. These measures are not uniformly defined or utilised by all companies. Accordingly, these measures may not be comparable with similarly titled measures used by other companies. Non-GAAP financial measures should not be viewed in isolation nor considered as a substitute for measures reported in accordance with NZ IFRS. These non-GAAP measures are not subject to audit.

Definitions of the non-GAAP measures used by Fonterra, and reconciliations of the NZ IFRS measures to the non-GAAP measures can be found on pages 48 to 49 of Fonterra's Interim Report that is available on Fonterra's website here.

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