

Fonterra

RESEARCH INSIGHTS[#]

FY19 Result — Bitter, Bitter, Sweet

Fonterra's (FSF) FY19 result had a plethora of moving parts, with some early bright spots from its strategic reset more than outweighed by a number of pressure areas, predominantly in its offshore divisions. Key positives were (1) debt reduction; (2) lower capex and opex; (3) improved gross margin in NZ Ingredients; albeit this was more than outweighed by margin pressure in the challenging Australian Ingredients and Latam consumer markets. FSF's more streamlined strategy and lower dividend payout appear sensible; however, we don't expect the planned turnaround to be smooth sailing, with multiple pressure points to tackle and a number of external factors which add volatility to manage.

What's changed?

- **Earnings:** EPS lowered due to asset divestments and a more conservative earnings recovery path, given disappointing FY20 Ingredients guidance.

Good progress with 'controllables'; negatively skewed divisional results

FSF reported FY19 normalised EPS of 17cps, down -28% on the prior year, albeit ahead of its recently downgraded guidance range of 10–15cps in late May, primarily due to no staff bonuses and a stronger 4Q. Asset sales, no dividend and lower capex has helped with (necessary) debt reduction.

Digging through the detail shows some positives (improved NZ Ingredients gross margins, lower opex and materially lower capex), albeit outweighed by material earnings pressure elsewhere (Australian Ingredients, Latam & Asia Consumer and Chile) from a challenging and highly competitive market.

Strategy — nothing revolutionary; back to basics

FSF's strategic review reveal is broadly consistent with pre-signalled themes, including: putting greater emphasis on its "core product" offerings by focussing on 'value over volume' and prioritising NZ milk pools. Under the new operating model, FSF will move from two primary businesses (Ingredients, and Consumer & Foodservice) to three geographic focussed, customer facing business divisions with the key objective being to create a leaner, 'go-to-market' operating model. We support a more streamlined, focussed business which has been arguably dictated by necessity. The focus now turns to delivery.

Where to from here? Earnings and dividend outlook

FSF provided first time FY20 EPS guidance of 15–25cps, a three year plan for 40cps and five year plan 50cps. Targets don't appear unrealistic at first glance, taking earnings back to recent levels (FY16/17). However, performance over the past few years has continued to underwhelm, hence materially improved execution is required to get confidence this recovery is achievable. Little detail has also been provided in terms of the medium-term pathway and key drivers.

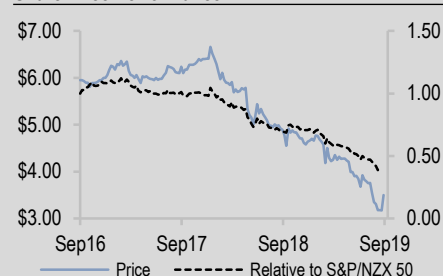
FSF revised its dividend payout to 40–60% of reported NPAT (prior 65–75%), with the intention to re-commence dividends in FY20 (subject to earnings and capital requirements). We view the lower policy as prudent in light of the co-op structure and task ahead to revitalise and turnaround the business trajectory.

Investment View

Fonterra is in the early stages of material strategic change following recent underperformance. Early progress has been made to improve its balance sheet, now the focus turns to earnings. Management has multiple pressure points to tackle and coupled with volatile input prices and competitive markets make this a complex task. Unitholder and shareholder conflicts also remain an issue for FSF investors.

NZX Code	FSF
Share price	NZ\$3.50
Issued shares	1612.0m
Market cap	NZ\$5,642m
Average daily turnover	279.2k (NZ\$1,230k)

Share Price Performance



Financials: July	19A	20E	21E	22E
NPAT* (NZ\$m)	272.0	349.6	508.1	573.3
EPS* (NZc)	16.9	21.7	31.5	35.6
EPS growth* (%)	-28.9	28.5	45.3	12.8
DPS (NZc)	0.0	9.0	17.0	20.0
Imputation (%)	0	0	0	0

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	8.5	8.7	7.8	7.5
EV/EBIT	14.6	15.1	12.7	11.8
PE	20.7	16.1	11.1	9.8
Price / NTA	1.8	1.6	1.5	n/a
Cash dividend yield (%)	0.0	2.6	4.9	5.7
Gross dividend yield (%)	0.0	2.6	4.9	5.7

*Historic and forecast numbers based on underlying profits

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[#]Forsyth Barr RESEARCH INSIGHTS targets selected smaller cap stocks or those under transitional coverage and focuses on qualitative rather than quantitative assessments. We do not provide investment ratings or target prices on these stocks.

Fonterra Shareholders' Fund (FSF)

Priced as at 26 Sep 2019: NZ\$3.50

July year end

Research Insights

Forsyth Barr Research Insights focuses on qualitative rather than quantitative assessments of an equity investment.

We do not provide valuation, target prices or investment ratings for companies in the Research Insights series. It is targeted at selected smaller cap stocks with typically higher risk attributes, or those under transitional coverage.

Our earnings and cashflow forecasts, together with key valuation and ratios provided on this page should assist investors in determining the relative valuation merits of the company.

Valuation Ratios

	2018A	2019A	2020E	2021E	2022E
EV/EBITDA (x)	8.0	8.5	8.7	7.8	7.5
EV/EBIT (x)	13.2	14.6	15.1	12.7	11.8
PE (x)	14.8	20.7	16.1	11.1	9.8
Price/NTA (x)	1.9	1.8	1.6	1.5	1.4
Free cash flow yield (%)	2.6	1.9	7.7	6.6	8.0
Net dividend yield (%)	2.9	0.0	2.6	4.9	5.7
Gross dividend yield (%)	2.9	0.0	2.6	4.9	5.7
Imputation (%)	0	0	0	0	0
Pay-out ratio (%)	42	0	41	54	56

Capital Structure

	2018A	2019A	2020E	2021E	2022E
Interest cover EBIT (x)	2.2	1.9	2.0	2.8	3.2
Interest cover EBITDA (x)	3.6	3.2	3.5	4.6	5.0
Net debt/ND+E (%)	50.9	50.9	44.6	42.5	40.3
Net debt/EBITDA (x)	4.6	4.4	3.9	3.5	3.2

Profit and Loss Account (NZ\$m)

	2018A	2019A	2020E	2021E	2022E
Sales revenue	20,431	20,114	19,816	20,619	21,060
Normalised EBITDA	1,392	1,355	1,256	1,334	1,393
Depreciation and amortisation	(544)	(561)	(528)	(516)	(515)
Normalised EBIT	848	794	728	819	878
Net interest	(390)	(418)	(361)	(291)	(276)
Associate income	54	25	35	47	55
Tax	(105)	(177)	(101)	(115)	(131)
Minority interests	25	(48)	(48)	(48)	(48)
Normalised NPAT	382	272	350	508	573
Abnormals/other	(603)	(829)	-	-	-
Reported NPAT	(221)	(557)	350	508	573
Normalised EPS (cps)	23.7	16.9	21.7	31.5	35.6
DPS (cps)	10.0	-	9.0	17.0	20.0

Key Ratios

	2018A	2019A	2020E	2021E	2022E
Return on assets (%)	4.7	4.7	4.5	5.0	5.3
Return on equity (%)	6.1	4.7	5.7	8.0	8.6
Return on funds employed (%)	4.4	1.8	3.7	5.2	5.6
EBITDA margin (%)	6.8	6.7	6.3	6.5	6.6
EBIT margin (%)	4.2	3.9	3.7	4.0	4.2
Capex to sales (%)	4.8	3.0	2.5	2.4	2.4
Capex to depreciation (%)	218	130	112	117	117

Operating Performance (NZ\$m)*

	2018A	2019A	2020E	2021E	2022E
Revenue					
Ingredients	16,306	17,035	17,035	17,546	17,722
Consumer & foodservices	7,122	7,011	6,660	6,993	7,343
China farms	262	249	240	245	250
Gross revenue	23,690	24,295	23,935	24,784	25,314
Internal sales	3,259	4,181	4,119	4,165	4,254
External revenue	20,431	20,114	19,816	20,619	21,060

Gross profit

	2018A	2019A	2020E	2021E	2022E
Ingredients	1,472	1,427	1,329	1,372	1,386
Consumer & foodservices	1,683	1,621	1,532	1,608	1,689
Unallocated & other	(3)	(33)	(20)	(10)	(5)
Total gross profit	3,152	3,015	2,840	2,971	3,070
Total operating expenses	2,496	2,311	2,208	2,252	2,297
Other income	192	91	96	100	105
Net foreign exchange gains/(losses)	-	(1)	-	-	-
Equity acc'd earnings/(losses)	54	25	35	47	55

Normalised EBIT

	2018A	2019A	2020E	2021E	2022E
Ingredients	879	811	623	653	653
Consumer & foodservices	525	450	524	582	644
Unallocated & other	(502)	(442)	(383)	(369)	(364)
Total normalised EBIT	902	819	763	866	933

*as reported by Fonterra

Growth Rates

	2018A	2019A	2020E	2021E	2022E
Revenue (%)	6.3	-1.6	-1.5	4.1	2.1
EBITDA (%)	-14.8	-2.7	-7.3	6.2	4.4
EBIT (%)	-23.4	-6.4	-8.3	12.5	7.2
Normalised NPAT (%)	-51.1	-28.8	28.5	45.3	12.8
Normalised EPS (%)	-51.2	-28.9	28.5	45.3	12.8
DPS (%)	-75.0	-100.0	n/a	88.9	17.6

Cash Flow (NZ\$m)

	2018A	2019A	2020E	2021E	2022E
EBITDA	1,392	1,355	1,256	1,334	1,393
Working capital change	179	(122)	132	(58)	(35)
Interest & tax paid	(514)	(469)	(461)	(406)	(408)
Other	63	(54)	-	-	-
Operating cash flow	1,120	710	926	871	951
Capital expenditure	(971)	(600)	(490)	(500)	(500)
(Acquisitions)/divestments	26	428	704	-	-
Other	(3)	176	-	-	-
Funding available/(required)	172	714	1,140	371	451
Dividends paid	(480)	(22)	(16)	(178)	(242)
Equity raised/(returned)	-	-	-	-	-
Increase/(decrease) in net debt	(104)	(1,396)	(1,124)	(193)	(208)

Balance Sheet (NZ\$m)

	2018A	2019A	2020E	2021E	2022E
Working capital	3,156	2,975	2,835	2,952	3,018
Fixed assets	6,810	6,512	6,171	6,164	6,158
Intangibles	3,227	2,597	2,586	2,578	2,569
Other assets	2,260	2,571	2,216	2,263	2,318
Total funds employed	15,453	14,655	13,808	13,957	14,063
Net debt/(cash)	6,453	6,020	4,896	4,703	4,495
Other non current liabilities	2,651	2,754	2,746	2,805	2,836
Shareholder's funds	6,219	5,804	6,089	6,372	6,655
Minority interests	130	77	77	77	77
Total funding sources	15,453	14,655	13,808	13,957	14,063

* Forsyth Barr target prices reflect valuation rolled forward at cost of equity less the next 12-months dividend

FY19 result summary

Figure 1. FY19 result summary

NZ\$m	FY18	FY19	% chg	Comments
Revenue				
Ingredients	16,306	17,035	4.5%	Robust growth in core NZ ingredients business
Consumer & Foodservices	7,122	7,011	-1.6%	Reduced butter sales in Asia decreased volumes
China Farms	262	249	-5.0%	Adverse animal health & weather subdued supply and volumes
Gross revenue	23,690	24,295	2.6%	
Internal sales	3,259	4,181	28.3%	
External revenue	20,431	20,114	-1.6%	
Gross margin				
Ingredients	1,472	1,427	-3.1%	Higher milk price and overcapacity in Australia coupled with pricing pressure in Latam
Consumer & Foodservices	1,683	1,621	-3.7%	Consumer gross margin down 8% due to Latam pricing pressure
Unallocated & other	(3)	(33)	nm	
Total gross margin	3,152	3,015	-4.3%	
Operating expenses	(2,496)	(2,311)	-7.4%	Largely driven by withdrawal of staff performance bonuses in FY19
Other income	192	91	-52.6%	
Net foreign exchange gains/(losses)	0	(1)	nm	
Equity acc'd earnings/(losses)	54	25	-53.7%	
Normalised EBIT				
Ingredients	879	811	-7.7%	Cost pressures across all geographies despite robust opex control
Consumer & Foodservices	525	450	-14.3%	Reduced opex offset by margin pressure across Latam/Oceania
Unallocated & other	(502)	(442)	-12.0%	Some reclassification to segments, coupled with lower advertising
Total normalised EBIT	902	819	-9.2%	
Abnormal items	(640)	(829)	29.5%	Broad range of asset impairments and one-off disposal losses
EBIT	262	(10)	-103.8%	
Interest	(416)	(418)	0.5%	Should be materially lower in future given debt reduction progress
Tax	(42)	(177)	321.4%	
Net profit after tax	(196)	(605)	208.7%	Primarily due to write-down and sale of major assets (pre signalled)
Minority interests	(25)	48	-292.0%	
Reported profit	(221)	(557)	152.0%	
Underlying profit	382	272	-28.8%	
Underlying EPS (cps)	23.7	16.9	-28.9%	Ahead of recently downgraded guidance of NZ10–15cps
Dividend (cps)	10.0	0.0	-100.0%	Pre-signalled, given FSF's debt reduction focus

Source: Forsyth Barr analysis, Company reports

Earnings revisions

We downgrade our near-term EPS profile reflecting recently announced asset sales and taking a more conservative view on the path to earnings recovery — with FY20 Ingredients EBIT guidance the key negative area vs. our prior expectations. Our updated FY20E EPS of 21.7cps compares to the early season, wide guidance range of 15–25cps. Our medium-term expectations are below Fonterra's 40cps target.

We also lower our dividend forecasts to incorporate Fonterra's revised dividend policy.

Figure 2. Earnings revisions (NZ\$m)

	FY19A Actual	Old	FY20E New	% chg	Old	FY21E New	% chg	FY22E New
Revenue	20,114	19,969	19,816	-0.8%	21,003	20,619	-1.8%	21,060
Normalised NPAT	272	411	350	-14.9%	583	508	-12.8%	573
Normalised EPS (cps)	16.9	25.5	21.7	-14.9%	36.1	31.5	-12.8%	35.6
Dividend (cps)	0.0	10.0	9.0	-10.0%	22.0	17.0	-22.7%	20.0

Source: Forsyth Barr analysis

Investment summary

Fonterra (FSF) is in the early stages of material strategic change to streamline and simplify its business. Initial steps have lowered elevated debt levels, now the focus turns to earnings. This is no easy task with multiple pressure points to tackle, in conjunction with external factors largely outside of its control (namely volatile input prices and changing supply & demand dynamics in the various international markets in which it operates).

Business quality

- **Industry structure:** FSF is one of the largest dairy manufacturers and exporters globally. It competes with several other international dairy businesses operating across commodity ingredients, consumer and foodservices products. The sector is highly competitive, and performance is influenced by international demand and supply dynamics and well as market specific factors.
- **Shareholder unitholder conflicts:** There is an inherent conflict of interest between farmer-shareholders, who prefer a higher Farmgate Milk Price (FGMP), and unitholders, who prefer a lower FGMP and higher dividend.

Earnings and cash flow outlook

- **Key earnings drivers:** Earnings are largely driven by the FGMP which FSF is required to pay its NZ farmer-shareholders for milk supply. The FGMP is based on global prices for reference commodity products (WMP, SMP, AMF, butter and BMP). The price differential between reference and non-reference (cheese and casein) products (stream profits/losses) can also have a material impact on earnings.
- **Earnings volatility:** It is difficult to have confidence in FSF's near-term earnings outlook given volatile input prices and the varied market dynamics of the multiple countries in which FSF operates.

Company description

Fonterra is the largest processor of milk and the largest dairy exporter globally. It is also a leader in consumer branded dairy products in Australia, New Zealand, Chile, and Asia. It is co-operative owned by c.10,500 NZ dairy farmers who currently supply c.75% of its milk intake. The co-op has undertaken significant capital expenditure in recent years to try and remove volatility associated with its ingredients business, as well as increase sales volumes of foodservice and consumer products. Trading Among Farmers allows external investors to invest in NZX and ASX listed units that mirror farmer shares.

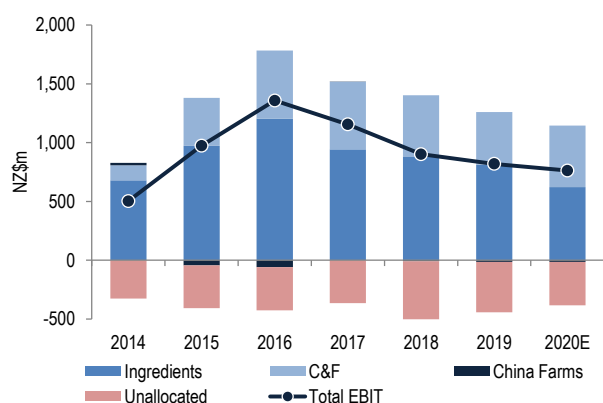
Financial structure

- **Gearing lowering:** Recent earnings decline has placed pressure on FSF's balance sheet. FSF's portfolio review has delivered debt reduction of c.NZ\$1bn through asset sales. FSF is forecasting gearing of 37–39% in FY20E vs 48% in FY19.

Risks factors

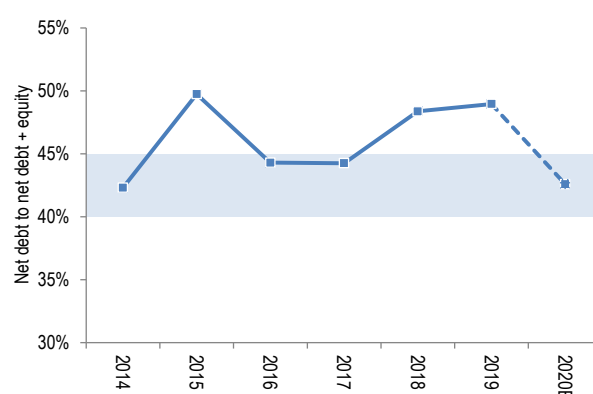
- **Biosecurity:** Food safety is a key risk to NZ dairy manufacturers given their reliance NZ's clean green image to obtain premium pricing for products.
- **Strategic change:** FSF is in the midst of material strategic change which creates both uncertainty and risk. Execution is key.

Figure 3. Normalised EBIT by segment



Source: Company reports, Forsyth Barr analysis

Figure 4. Gearing vs FSF target band



Source: Company reports, Forsyth Barr analysis

Figure 5. Substantial Shareholders

Shareholder	Latest Holding
FSF Management Company	6.9%

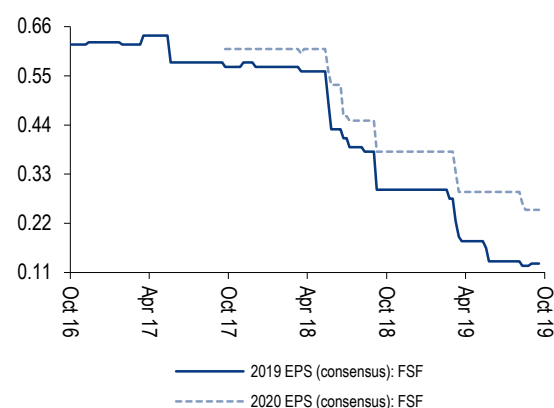
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 6. International Compcos

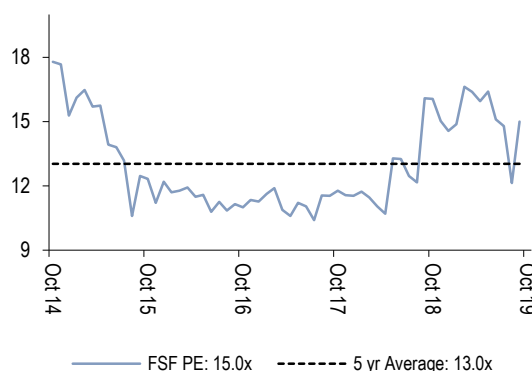
Company	Code	Price	Mkt Cap	PE	EV/EBITDA	EV/EBIT	Cash D/Yld
<i>(metrics re-weighted to reflect FSF's balance date - July)</i>							
Fonterra	FSF NZ	NZ\$3.50	NZ\$5,642	16.1x	11.1x	9.3x	4.9%
Danone SA	BN FP	€79.88	€54,806	19.7x	18.1x	13.8x	2.9%
Nestle SA	NESN SW	CHF107.94	CHF321,229	23.3x	21.7x	17.3x	2.7%
Saputo Inc	SAP CN	C\$40.66	C\$16,575	22.6x	20.1x	13.7x	n/a
Bega Cheese	BGA AT	A\$4.56	A\$975	24.3x	18.3x	10.7x	2.7%
Kerry Group PLC	KYG ID	€107.20	€18,920	26.0x	23.6x	18.9x	0.9%
Inner Mongolia Yili Industrial Group Co	600887 CH	CN¥28.05	CN¥171,024	23.2x	20.4x	16.5x	3.1%
China Mengniu Dairy Co	2319 HK	CN¥28.85	CN¥113,451	24.7x	22.0x	15.3x	1.1%
Compcos Average:				23.4x	20.6x	15.2x	2.2%
FSF Relative:				-31%	-46%	-39%	+119%

EV = Current Market Cap + Actual Net Debt

Source: *Forsyth Barr analysis, Bloomberg Consensus, Compcos metrics re-weighted to reflect headline (FSF) companies fiscal year end

Figure 7. Consensus EPS Momentum


Source: Forsyth Barr analysis

Figure 8. 12 Month Forward PE


Source: Forsyth Barr analysis

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