FORSYTH BARR

NEW ZEALAND EQUITY RESEARCH | FOOD, BEVS, & AGRI | INTL DAIRY PRODUCER
19 MARCH 2020

Fonterra
1H20 Result — Making Moo-ve's

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RESEARCH INSIGHTS

Fonterra (FSF) reported a strong EPS recovery in 1H20, with signs of continued improvement and discipline following its strategic reset, however, near-term outlook is clouded by uncertainties around the global impact of COVID-19 and drought conditions in Australasia. There were a number of positives in 1H20 including (1) debt reduction; (2) lower capex and opex; (3) strong uplift in Consumer and Foodservice earnings; and (4) positive net cash flow, which outweighed weakness in NZ Ingredients given product mix pressures. FY20 EPS guidance was retained to reflect the uncertainty. The current run-rate suggests upside risk to our forecasts, although things can change quickly given a number of dynamics outside of FSF's control (namely changing supply and demand dynamics globally), amplified by uncertainty from COVID-19.

NZX Code	FSF
Share price	NZ$3.78
Issued shares	1612.0m
Market cap	NZ$6,093m
Avg daily turnover	174.7k (NZ$679k)

Financials: Jul/	19A	20E	21E	22E
NPAT* (NZ$m)	272.0	350.2	507.9	573.4
EPS* (NZc)	16.9	21.7	31.5	35.6
EPS growth* (%)	-28.9	28.8	45.0	12.9
DPS (NZc)	0.0	9.0	17.0	20.0
Imputation (%)	0	0	0	0

*Based on normalised profits

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	8.9	9.1	8.1	7.8
EV/EBIT	15.1	15.7	13.2	12.3
PE	22.4	17.4	12.0	10.6
Price / NTA	1.9	1.7	1.6	1.5
Cash div yld (%)	0.0	2.4	4.5	5.3
Gross div yld (%)	0.0	2.4	4.5	5.3

Strong start to FY20, with a number of internal initiatives delivering early positive signs, albeit helped by weak base

FSF's 1H20 result was operationally strong (off a weak comparative) with normalised EPS of 18cps, up significantly from 4cps in the prior year and well ahead of our forecasts. It is an encouraging start following a suite of strategic changes, and particularly in the context of a high Farmgate Milk Price (NZ$7–$7.60) and drought conditions in Australasia.

FSF reported a step-change in Consumer & Foodservices (EBIT up +105%), as a result of strong demand for products in Greater China and Asia. The result also saw a steep decline in both capex and opex as strategic initiatives begin to deliver benefits. Dampening the uplift was a weak performance in NZ Ingredients (EBIT down -5%), driven by a -17% decline in gross margin per MT in non-reference products as a result of higher sales volume of UHT cream (a low margin ingredients product).

Guidance retained in light of uncertainties; strong 1H leaves it well placed

Despite the strong start to FY20, FSF has maintained its guidance for underlying EPS of 15–25cps. The company is tracking well to the top end, although retains "prudence" given the high level of uncertainties in the current environment. FSF also flagged an expected EBITDA impact of NZ$40–50m on its China Foodservice business from COVID-19. At this point we leave our forecasts unchanged — the current run-rate suggests upside risk, although uncertainty leaves us more cautious.

Strategic review and balance sheet — moving in the right direction, but more work to do

FSF is in the midst of a material strategic overhaul, targeted at lowering debt levels and improving earnings/margins, both of which have been key areas of challenge in recent years. The 1H20 result showed early progress, however, there is more work to do. Net debt saw a notable decrease in 1H20 to NZ$5.8bn from NZ$7.4bn, however, gearing levels of 46.9% remain outside of its target range (40–45%). This reflects the improved earnings/cashflow result, material asset sales and no interim dividend. Going forward, FSF has signalled pending sales of China Farms and DPA Brazil and hopes to reinstate a dividend at the FY20 result. There remain a plethora of moving parts, hence, the latter will be contingent on results.

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Fonterra Shareholders' Fund (FSF)

Priced as at 18 Mar 2020 (NZ$) **3.78**

Research Insights

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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.

Profit and Loss Account (NZ$m)	2018A	2019A	2020E	2021E	2022E
Sales revenue	20,431.0	20,114.0	19,816.3	20,619.1	21,060.1
Normalised EBITDA	**1,392.0**	**1,355.0**	**1,255.9**	**1,334.2**	**1,392.7**
Depreciation and amortisation	(544.0)	(561.0)	(527.9)	(515.5)	(514.8)
Normalised EBIT	**848.0**	**794.0**	**728.0**	**818.7**	**877.9**
Net interest	(390.0)	(418.0)	(360.1)	(290.8)	(276.2)
Associate income	54.0	25.0	35.0	47.0	55.0
Tax	(105.0)	(177.0)	(100.7)	(115.0)	(131.3)
Minority interests	25.0	(48.0)	(48.0)	(48.0)	(48.0)
Normalised NPAT	**382.0**	**272.0**	**350.2**	**507.9**	**573.4**
Abnormals/other	(603.0)	(829.0)	0	0	0
Reported NPAT	**(221.0)**	**(557.0)**	**350.2**	**507.9**	**573.4**
Normalised EPS (cps)	23.7	16.9	21.7	31.5	35.6
DPS (cps)	10.0	0	9.0	17.0	20.0

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	28.8	45.0	12.9
Normalised EPS (%)	-51.2	-28.9	28.8	45.0	12.9
Ordinary DPS (%)	-75.0	-100.0	n/a	88.9	17.6

Cash Flow (NZ$m)	2018A	2019A	2020E	2021E	2022E
EBITDA	**1,392.0**	**1,355.0**	**1,255.9**	**1,334.2**	**1,392.7**
Working capital change	179.0	(122.0)	131.5	(57.9)	(34.6)
Interest & tax paid	(514.0)	(469.0)	(460.8)	(405.7)	(407.5)
Other	63.0	(54.0)	0	0	0
Operating cash flow	**1,120.0**	**710.0**	**926.6**	**870.5**	**950.5**
Capital expenditure	(971.0)	(600.0)	(490.0)	(500.0)	(500.0)
(Acquisitions)/divestments	26.0	428.0	704.0	0	0
Other	2.0	192.0	0	0	0
Funding available/(required)	**177.0**	**730.0**	**1,140.6**	**370.5**	**450.5**
Dividends paid	(480.0)	(22.0)	7.7	(201.9)	(242.2)
Equity raised/(returned)	0	0	0	0	0
(Increase)/decrease in net debt	**(303.0)**	**708.0**	**1,148.3**	**168.6**	**208.4**

Balance Sheet (NZ$m)	2018A	2019A	2020E	2021E	2022E
Working capital	3,156.0	2,975.0	2,835.0	2,952.5	3,018.5
Fixed assets	6,810.0	6,512.0	6,170.7	6,163.9	6,157.5
Intangibles	3,227.0	2,597.0	2,586.4	2,577.7	2,569.4
Right of use asset	0	0	0	0	0
Other assets	2,260.0	2,571.0	2,216.0	2,263.0	2,318.0
Total funds employed	**15,453.0**	**14,655.0**	**13,808.1**	**13,957.1**	**14,063.4**
Net debt/(cash)	6,453.0	6,020.0	4,871.7	4,703.0	4,494.7
Lease liability	0	0	0	0	0
Other liabilities	2,651.0	2,754.0	2,745.5	2,805.1	2,836.5
Shareholder's funds	6,219.0	5,804.0	6,113.9	6,372.0	6,655.2
Minority interests	130.0	77.0	77.0	77.0	77.0
Total funding sources	**15,453.0**	**14,655.0**	**13,808.1**	**13,957.1**	**14,063.4**

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

Valuation Ratios	2018A	2019A	2020E	2021E	2022E
EV/EBITDA (x)	8.4	8.9	9.1	8.1	7.8
EV/EBIT (x)	13.7	15.1	15.7	13.2	12.3
PE (x)	15.9	22.4	17.4	12.0	10.6
Price/NTA (x)	2.0	1.9	1.7	1.6	1.5
Free cash flow yield (%)	2.4	1.8	7.2	6.1	7.4
Net dividend yield (%)	2.6	0.0	2.4	4.5	5.3
Gross dividend yield (%)	2.6	0.0	2.4	4.5	5.3

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	44.3	42.5	40.3
Net debt/EBITDA (x)	4.6	4.4	3.9	3.5	3.2

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
Imputation (%)	0	0	0	0	0
Pay-out ratio (%)	42	0	41	54	56

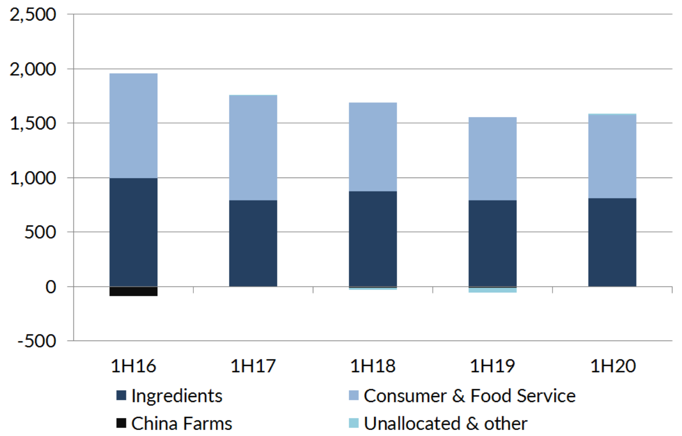
Operating Performance	2018A	2019A	2020E	2021E	2022E
Revenue					
Ingredients	16,306	17,035	17,035	17,546	17,722
Consumer & foodservices	7,122	7,011	6,660	6,993	7,343
China farms	262	249	240	245	250
Gross revenue	**23,690**	**24,295**	**23,935**	**24,784**	**25,314**
Internal sales	3,259	4,181	4,119	4,165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

Figure 1. Normalised like-for-like performance (continuing operations)

NZ$m	1H19	1H20	% chg	Forsyth Barr	% diff
Revenue	9,428	10,071	6.8%	9,843.5	2.3%
Gross Profit	1,448	1,588	9.7%		
EBIT	335	561	67.5%	436	28.8%
NPAT	72	293	306.9%	200	46.8%
EPS (cps)	4.7	18	281.8%	12.4	45.4%
Dividend (cps)	0	0	0.0%	2.5	n/a

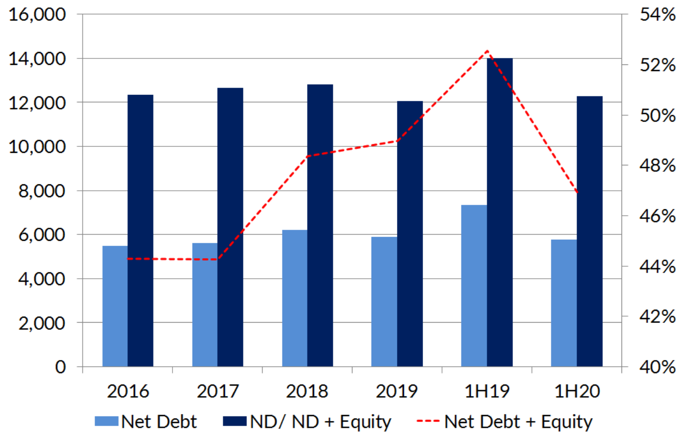
Source: Forsyth Barr analysis, Company reports

Figure 2. Gross profit by segment



Source: Forsyth Barr analysis, Company reports

Figure 3. Gearing levels



Source: Forsyth Barr analysis, Company reports

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). The strong 1H20 result was an encouraging start.

Business quality

- **Industry structure:** FSF is one of the largest dairy manufacturers and exporters globally. It competes with multiple 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 cashflow 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. COVID-19 adds further uncertainty.

Financial structure

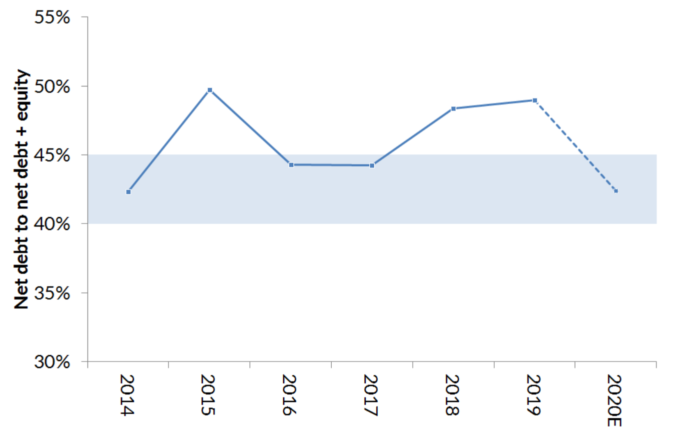
- **Gearing lowering, albeit still high:** FSF's portfolio review has delivered debt reduction of c.NZ$1bn through asset sales. This, in conjunction with a strong lift in 1H20 earnings (off a weak base) has materially lowered gearing. There is still more to do, including the signalled sale of problematic offshore assets.

Risk factors

- **Biosecurity:** Food safety is a key risk to NZ dairy manufacturers given their reliance on NZ's clean green image to get premium pricing for products.

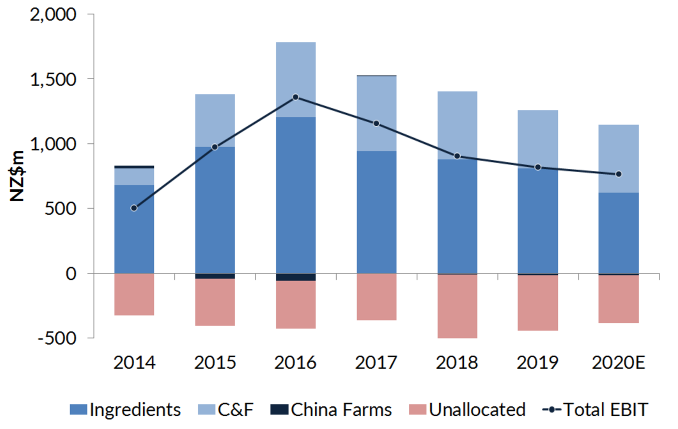
- **Strategic change:** FSF is in the midst of material strategic change which creates both uncertainty and risk. Execution is key.

Figure 4. Gearing vs. FSF target band



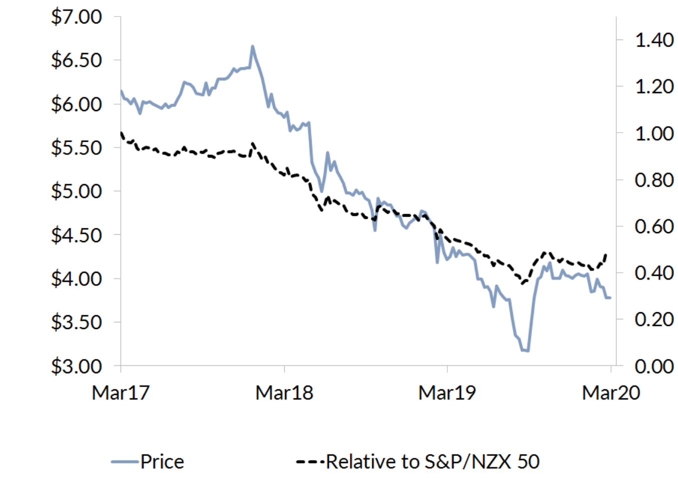
Source: Forsyth Barr analysis, Company reports

Figure 5. Normalised EBIT by segment



Source: Forsyth Barr analysis, Company reports

Figure 6. Price performance



Source: Forsyth Barr analysis

Figure 7. Substantial shareholders

Shareholder	Latest Holding
FSF Management Company	6.9%

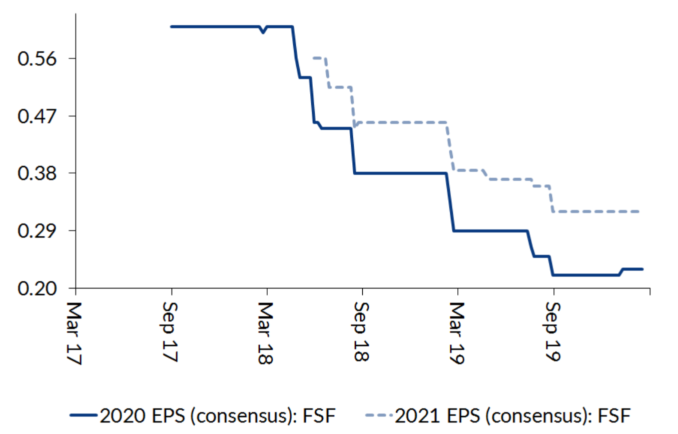
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 8. International valuation comparisons

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash Yld
(metrics re-weighted to reflect FSF's balance date - July)			(m)	2020E	2021E	2020E	2021E	2020E	2021E	2021E
Fonterra	**FSF NZ**	**NZ$3.78**	**NZ$6,093**	**17.4x**	**12.0x**	**9.6x**	**9.1x**	**16.6x**	**14.8x**	**4.5%**
DANONE	BN FP	€58.12	€39,877	16.6x	12.9x	10.9x	10.2x	14.5x	12.7x	4.3%
NESTLE SA-REG	NESN SW	CHF93.83	CHF279,238	21.1x	19.7x	15.4x	15.0x	19.0x	18.5x	3.1%
SAPUTO INC	SAP CN	C$32.37	C$13,214	17.6x	12.1x	11.0x	10.1x	15.5x	13.6x	n/a
BEGA CHEESE	BGA AT	A$4.25	A$911	31.4x	19.4x	12.2x	9.7x	21.8x	15.1x	2.7%
KERRY GROUP PLC-A	KYG ID	€99.35	€17,539	26.4x	22.0x	18.6x	16.0x	23.4x	20.0x	0.9%
INNER MONGOLIA YILI INDUS-A	600887 CH	CN¥27.78	CN¥169,357	23.0x	20.5x	16.2x	14.1x	20.1x	17.7x	3.1%
CHINA MENGNIU DAIRY CO	2319 HK	CN¥25.80	CN¥101,540	21.4x	20.3x	13.9x	12.1x	19.3x	17.0x	1.2%
			Compco Average:	**22.5x**	**18.1x**	**14.0x**	**12.5x**	**19.1x**	**16.4x**	**2.6%**
EV = Current Market Cap + Actual Net Debt			**FSF Relative:**	**-23%**	**-34%**	**-31%**	**-27%**	**-13%**	**-10%**	**76%**

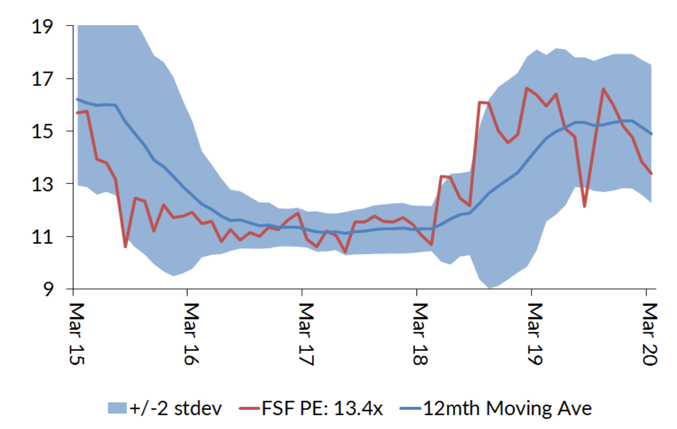
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (FSF) companies fiscal year end

Figure 9. Consensus EPS momentum (NZ$)



Source: Forsyth Barr analysis

Figure 10. One year forward PE (x)



Source: Forsyth Barr analysis

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