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Fonterra
FY20 Result; Turning the Corner

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RESEARCH INSIGHTS

Fonterra (FSF) reported an improved FY20 result (both earnings and gearing), delivering on guidance following its strategic reset and navigating a challenging period well. There is still work to do, particularly to deliver a more consistent and improved earnings/returns profile. The co-op remains committed to its medium-term targets (EPS of 50cps in FY24E) which is ahead of our expectations. Fonterra is also in the early stages of a review of its capital structure which adds some uncertainty.

NZX Code	FSF
Share price	NZ$4.06
Issued shares	1612.1m
Market cap	NZ$6,545m
Avg daily turnover	182.1k (NZ$699k)

Financials: Jul/	20A	21E	22E	23E
NPAT* (NZ$m)	382.0	468.3	521.1	572.4
EPS* (NZc)	23.7	29.0	32.3	35.5
EPS growth* (%)	42.0	22.6	11.3	9.8
DPS (NZc)	5.0	13.0	16.0	18.0
Imputation (%)	100	100	100	100
*Based on normalised profits				

Valuation (x)	20A	21E	22E	23E
PE	17.1	14.0	12.6	11.4
EV/EBIT	13.5	13.1	12.3	11.8
EV/EBITDA	7.8	7.5	7.2	6.9
Price / NTA	1.3	1.2	1.1	1.1
Cash div yld (%)	1.2	3.2	3.9	4.4
Gross div yld (%)	1.7	4.4	5.5	6.2

- **Earnings revisions:** We take a more conservative view on near-term earnings (FY21 EPS -6%) given the uncertain backdrop, amplified by various government restrictions. We also materially lower our dividend forecasts (FY21E 13cps, revised from 17cps).

Improved FY20 result

Fonterra reported an improved FY20 result at the top end of its guidance range. Normalised EPS of 24cps was up +42% and compares to guidance of 15-25cps and our expectation of 22cps. The underlying result was stronger again when adjusted for other significant items totalling -6cps (impairments and provisions). There are a number of moving parts with any FSF result and FY20 is no different.
- FSF's core **Ingredients** segment was solid (EBIT +5%), albeit helped by favourable stream returns in 2H20.
- **Foodservice** held up well (EBIT +14%), with a very strong 1H20 helping outweigh a COVID-19 disrupted 2H. China rebounded quickly post lockdowns (albeit is not yet operating at 100%), while Asia and Oceania remain weak given government restrictions.
- **Consumer** was weak (normalised EBIT -10%) with material headwinds in Hong Kong and Chile, outpacing strength in Australasia.

Material debt reduction enables a return of dividend payments, albeit at low end of policy range

Fonterra has made good progress on lowering its debt and gearing, helped by a suite of asset sales. There is still more work to do, including additional asset sales. FY20 gearing of 41.4% is materially below the prior year, the lowest level since FY13 and at the lower end of its target range (40-45%). Fonterra reinstated a dividend at 5cps (~41% of 2H20 EPS) after a period of hiatus. However, the level was well below our (and market) expectations and at the lower end of its payout range.

An (unsurprisingly) wide guidance range, albeit softer than anticipated; still more work to do

FY21 EPS guidance of 20-35cps encompasses most feasible scenarios, and Fonterra reaffirmed its milk price guidance of NZ$5.90-6.90. The former is softer than we expected, with the wide range also a reminder that even categories with proven resilience through the cycle are not immune to COVID-19 challenges. The co-op continues to move in the right direction following its strategic reset (albeit EPS is still well below levels achieved previously). The focus from here is for consistency and further EPS improvement (both a challenge historically) particularly to reach its medium-term targets. This isn't helped by environmental requirements and near-term uncertainty from COVID-19; with the latter reflected in the wide FY21 EPS guidance range and conservative FY20 dividend payout.

Fonterra Shareholders' Fund (FSF)

Priced as at 18 Sep 2020 (NZ$)	**4.06**

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.

Profit and Loss Account (NZ$m)	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Sales revenue	20,114	20,282	20,131	20,062	20,152
Normalised EBITDA	**1,380**	**1,497**	**1,460**	**1,507**	**1,557**
Depreciation and amortisation	(561)	(627)	(625)	(631)	(641)
Normalised EBIT	**819**	**870**	**835**	**876**	**916**
Net interest	(418)	(304)	(242)	(217)	(193)
Associate income	25	(6)	(6)	(6)	(6)
Tax	(177)	(175)	(119)	(132)	(145)
Minority interests	(48)	(27)	0	0	0
Normalised NPAT	**269**	**382**	**468**	**521**	**572**
Abnormals/other	(829)	412	0	0	0
Reported NPAT	**(532)**	**824**	**468**	**521**	**572**
Normalised EPS (cps)	16.7	23.7	29.0	32.3	35.5
DPS (cps)	0	5.0	13.0	16.0	18.0

Growth Rates	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Revenue (%)	-1.6	0.8	-0.7	-0.3	0.4
EBITDA (%)	-4.6	8.5	-2.5	3.2	3.3
EBIT (%)	-9.2	6.2	-4.0	4.9	4.6
Normalised NPAT (%)	-38.7	42.0	22.6	11.3	9.8
Normalised EPS (%)	-38.7	42.0	22.6	11.3	9.8
Ordinary DPS (%)	-100.0	n/a	>100	23.1	12.5

Cash Flow (NZ$m)	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
EBITDA	**1,380**	**1,497**	**1,460**	**1,507**	**1,557**
Working capital change	136	(67)	(45)	(60)	(42)
Interest & tax paid	(595)	(479)	(361)	(349)	(338)
Other	0	0	0	0	0
Operating cash flow	**921**	**951**	**1,054**	**1,098**	**1,177**
Capital expenditure	(632)	(400)	(586)	(646)	(696)
(Acquisitions)/divestments	0	(37)	0	0	0
Other	0	0	0	0	0
Funding available/(required)	**289**	**514**	**468**	**452**	**481**
Dividends paid	(22)	(29)	(210)	(258)	(290)
Equity raised/(returned)	0	0	0	0	0
(Increase)/decrease in net debt	**267**	**485**	**259**	**194**	**190**

Balance Sheet (NZ$m)	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Working capital	1,441	1,508	1,553	1,614	1,656
Fixed assets	6,512	6,006	5,983	6,017	6,093
Intangibles	2,597	2,240	2,191	2,141	2,088
Right of use asset	0	569	569	569	569
Other assets	2,571	3,213	3,222	3,231	3,240
Total funds employed	**13,121**	**13,536**	**13,519**	**13,571**	**13,646**
Net debt/(cash)	6,020	4,680	4,398	4,181	3,968
Lease liability	0	604	604	604	604
Other liabilities	1,220	946	946	946	946
Shareholder's funds	5,881	7,333	7,598	7,867	8,155
Minority interests	0	(27)	(27)	(27)	(27)
Total funding sources	**13,121**	**13,536**	**13,519**	**13,571**	**13,646**

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

Valuation Ratios	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
EV/EBITDA (x)	9.0	7.8	7.5	7.2	6.9
EV/EBIT (x)	15.1	13.5	13.1	12.3	11.8
PE (x)	24.3	17.1	14.0	12.6	11.4
Price/NTA (x)	2.0	1.3	1.2	1.1	1.1
Free cash flow yield (%)	4.4	8.4	7.2	6.9	7.3
Net dividend yield (%)	0.0	1.2	3.2	3.9	4.4
Gross dividend yield (%)	0.0	1.7	4.4	5.5	6.2

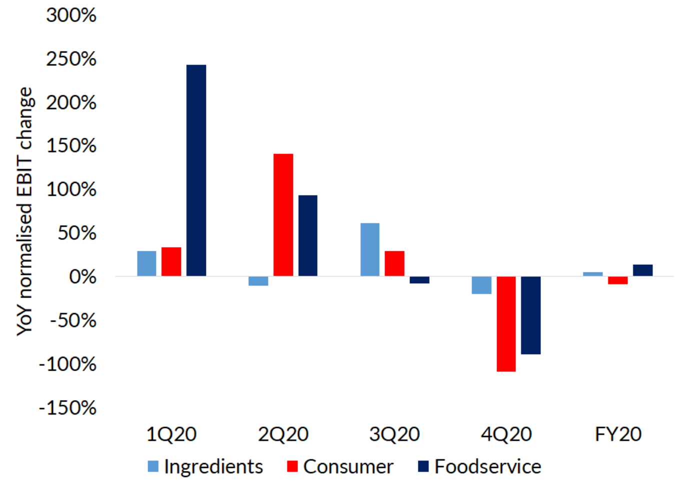
Capital Structure	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Interest cover EBIT (x)	2.0	2.9	3.4	4.0	4.7
Interest cover EBITDA (x)	3.3	4.9	6.0	7.0	8.1
Net debt/ND+E (%)	50.6	39.0	36.7	34.7	32.7
Net debt/EBITDA (x)	4.4	3.1	3.0	2.8	2.5

Key Ratios	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Return on assets (%)	4.8	4.9	4.7	5.0	5.2
Return on equity (%)	4.6	5.2	6.2	6.6	7.0
Return on funds employed (%)	5.2	5.8	6.0	6.2	6.4
EBITDA margin (%)	6.9	7.4	7.3	7.5	7.7
EBIT margin (%)	4.1	4.3	4.1	4.4	4.5
Capex to sales (%)	3.1	2.0	2.9	3.2	3.5
Capex to depreciation (%)	138	76	111	122	130
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	0	21	45	49	51

Operating Performance	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Revenue (NZ$m)					
Ingredients	17,035	17,365	16,669	16,269	16,075
Consumer	4,642	4,093	4,219	4,310	4,404
Foodservice	2,369	2,599	2,744	2,900	3,048
China farms	249	0	0	0	0
Gross revenue	24,295	24,057	23,632	23,479	23,527
Internal revenue	(4,181)	(3,985)	(3,500)	(3,416)	(3,376)
External revenue	**20,114**	**20,282**	**20,131**	**20,062**	**20,152**
Operating data					
Milk solids collected (KgMS, m)	1,523	1,516	1,535	1,535	1,535
FGMP (NZ$)	6.35	7.14	6.40	6.40	6.40
Gross profit	3,015	3,046	2,993	3,124	3,237
Cost breakdown					
Selling and marketing expense	(590)	(551)	(527)	(552)	(574)
Distribution expenses	(561)	(482)	(463)	(492)	(504)
Administrative expenses	(773)	(835)	(843)	(869)	(895)
Other operating expenses	(387)	(377)	(381)	(392)	(404)
Total operating expenses	**(2,311)**	**(2,245)**	**(2,215)**	**(2,304)**	**(2,377)**

Charts of interest

Figure 1. COVID-19 volatility; a mixed bag



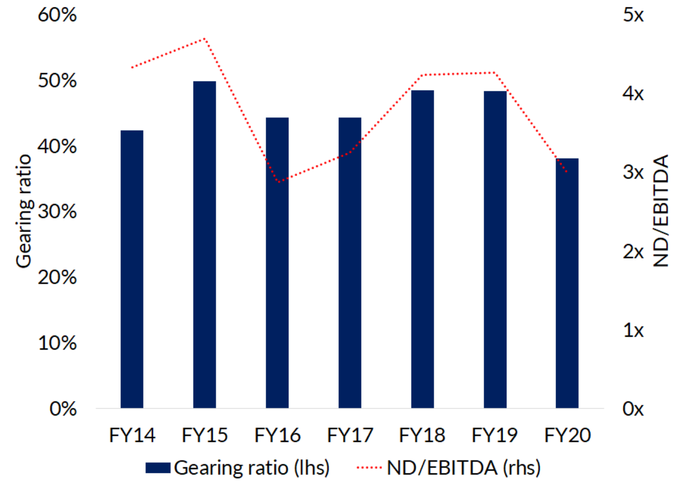
Source: Forsyth Barr analysis, Company reports

Figure 2. Notable category divergence but foodservice recovering

	Australia		US		China	
	Foodservice	Food retail	Foodservice	Food retail	Foodservice	Food retail
Dec-19	2%	3%	5%	2%	9%	2%
Jan-20	1%	3%	6%	2%	-43%	2%
Feb-20	2%	3%	5%	4%	-43%	4%
Mar-20	-23%	27%	-27%	29%	-47%	29%
Apr-20	-50%	5%	-52%	12%	-30%	12%
May-20	-35%	13%	-38%	15%	-19%	15%
Jun-20	-17%	14%	-26%	12%	-15%	12%
Jul-20	n/a	n/a	-19%	11%	-11%	7%

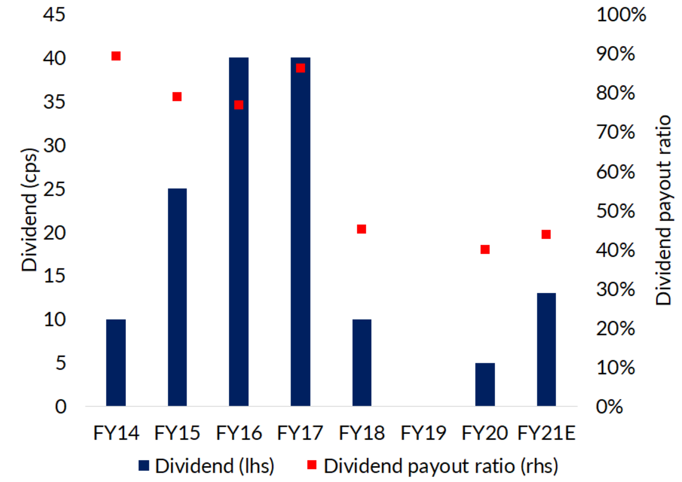
Source: Forsyth Barr analysis, Rabobank

Figure 3. Meaningful reduction in gearing



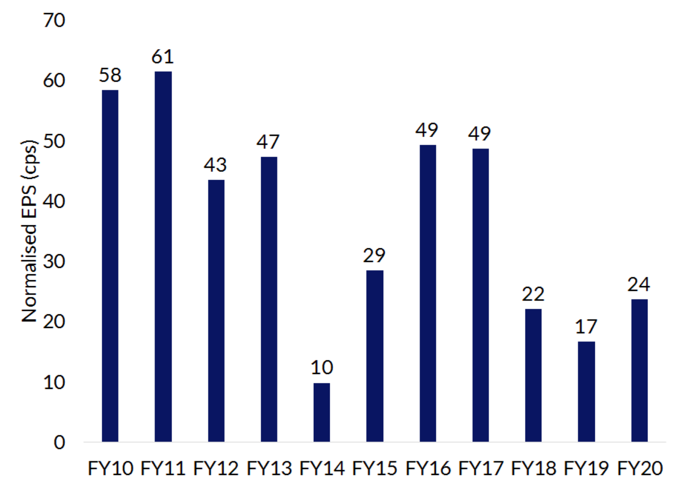
Source: Forsyth Barr analysis, Company reports

Figure 4. Return of the dividend



Source: Forsyth Barr analysis, Company reports. NB; FY18 is normalised profit (rest reported)

Figure 5. EPS remains depressed on prior levels



Source: Forsyth Barr analysis, Company reports

Figure 6. FY20 result summary

NZ$m	FY19 (restated)	FY20	% chg
Revenue	19,920	20,975	+5%
Normalised gross profit	3,008	3,208	+7%
Normalised EBIT	812	879	+8%
Underlying EPS (cps)	16	24	+50%
Dividend (cps)	0	5	n/a

Source: Forsyth Barr analysis, Company reports

Investment Summary

Fonterra is a New Zealand based co-operative, owned and supplied by its dairy farmer shareholders. It is one of the largest processors of milk and a leading global dairy exporter. Fonterra also owns a number of well-known, leading dairy brands across a variety of geographies including Anchor, Anmum, Anlene and Mainland. Fonterra Shareholders' Fund (FSF) allows external investors the opportunity to participate in the economic returns of Fonterra. FSF unitholders are exposed to the dividends and capital gains on the underlying value of the farmer owned shares, but have no voting rights.

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 as reflected by its wide earnings guidance range.

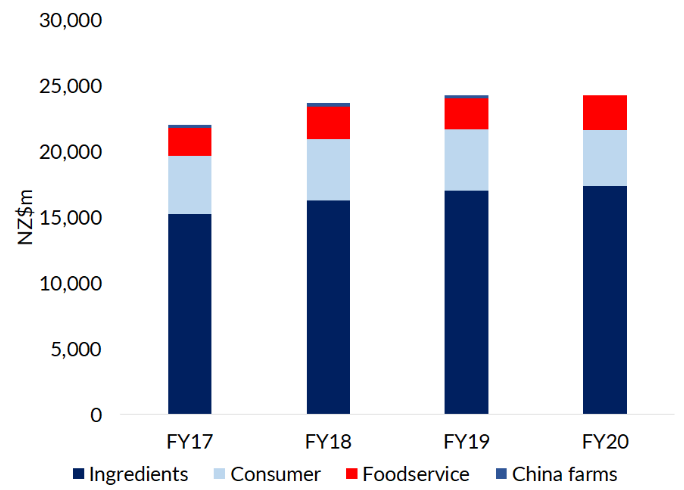
Financial structure

- **Meaningful gearing reduction; recent dividend reinstatement:** FSF's portfolio review has delivered debt reduction of c.NZ$1.1bn primarily through asset sales. This, in conjunction with a strong lift in earnings (off a weak base) has materially lowered gearing and enabled the reinstatement of its dividend from 2H20. Fonterra is also focussed on further lowering debt levels.

Risk factors

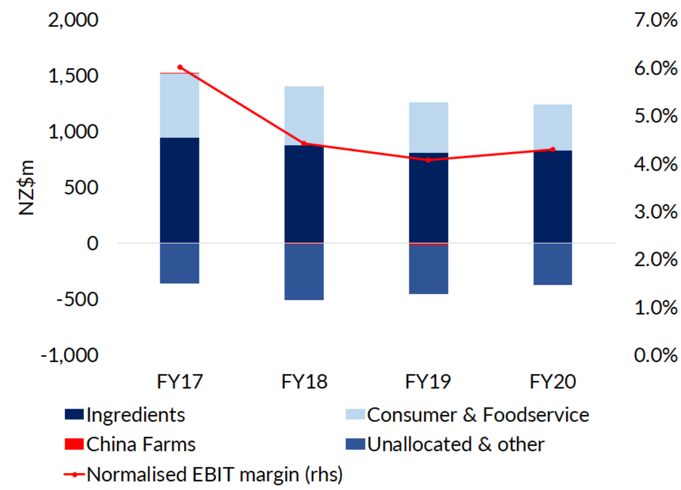
- **Biosecurity:** Food safety is a key risk to NZ dairy manufacturers given their reliance on NZ's clean green image to get premium pricing for products.
- **Multitude of uncontrollable factors:** FSF are exposed to a number of factors outside of its control that can have a material impact on earnings most notably the highly volatile global dairy demand and supply dynamics. COVID-19 adds further risk.

Figure 7. External revenue breakdown



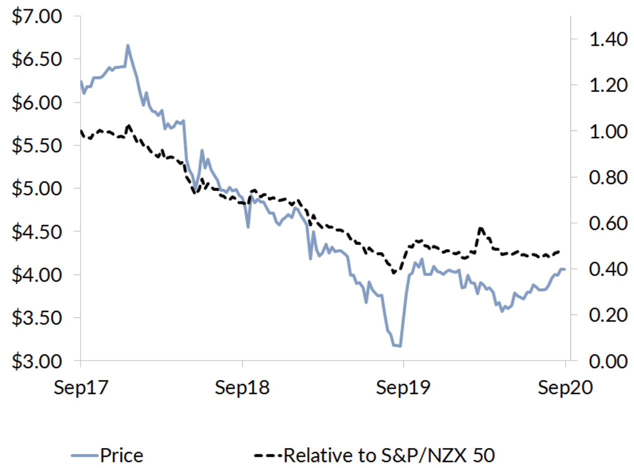
Source: Forsyth Barr analysis, Company reports

Figure 8. Normalised EBIT breakdown



Source: Forsyth Barr analysis, Company reports

Figure 9. Price performance



Source: Forsyth Barr analysis

Figure 10. Substantial shareholders

Shareholder	Latest Holding
FSF Management Company	6.9%

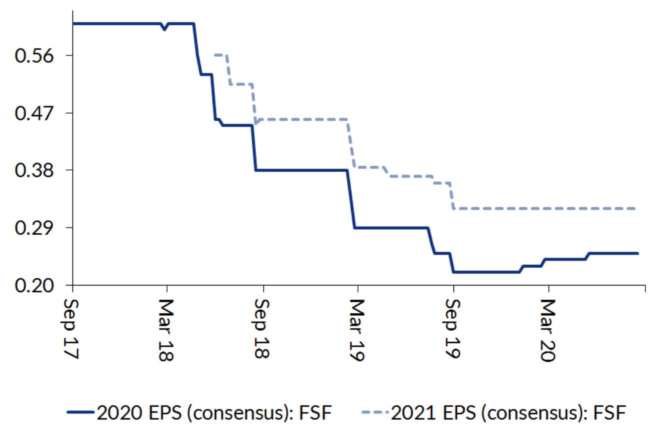
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 11. 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)	2021E	2022E	2021E	2022E	2021E	2022E	2022E
Fonterra	**FSF NZ**	**NZ$4.06**	**NZ$6,545**	**14.0x**	**12.6x**	**7.7x**	**7.4x**	**13.4x**	**12.8x**	**3.9%**
DANONE	BN FP	57.34	39,371	16.2x	15.1x	11.3x	10.7x	14.7x	13.9x	3.9%
NESTLE SA-REG	NESN SW	CHF108.42	CHF312,358	24.6x	23.0x	18.1x	17.4x	22.7x	21.7x	2.7%
SAPUTO INC	SAP CN	C$32.74	C$13,402	18.3x	n/a	11.0x	10.5x	15.7x	n/a	n/a
BEGA CHEESE	BGA AT	A$5.31	A$1,142	25.0x	20.3x	11.0x	9.9x	18.1x	15.2x	2.6%
KERRY GROUP PLC-A	KYG ID	113.50	20,054	30.2x	27.1x	20.9x	19.2x	27.6x	25.0x	0.8%
INNER MONGOLIA YILI INDUS-A	600887 CH	CN39.35	CN239,374	30.7x	26.2x	21.1x	18.1x	26.0x	22.5x	2.6%
CHINA MENGNIU DAIRY CO	2319 HK	CN35.15	CN138,711	32.6x	24.7x	19.7x	15.7x	30.1x	21.7x	0.9%
			Compco Average:	**25.4x**	**22.7x**	**16.2x**	**14.5x**	**22.1x**	**20.0x**	**2.3%**
EV = Current Market Cap + Actual Net Debt			**FSF Relative:**	**-45%**	**-45%**	**-52%**	**-49%**	**-39%**	**-36%**	**75%**

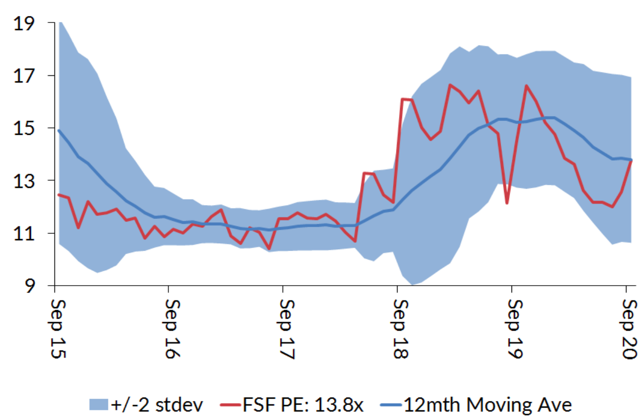
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (FSF) companies fiscal year end

Figure 12. Consensus EPS momentum (NZ$)



Source: Forsyth Barr analysis

Figure 13. One year forward PE (x)



Source: Forsyth Barr analysis

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