FORSYTH BARR

NEW ZEALAND EQUITY RESEARCH | FOOD, BEVS, & AGRI | INTL DAIRY PRODUCER
18 MARCH 2021

Fonterra
1H21 Result — Bitter Sweet

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RESEARCH INSIGHTS

Fonterra (FSF) reported a strong 1H21 result, led by outperformance in Greater China, albeit retained FY21 guidance signalling material margin pressure in 2H21 given the recent rapid rise in the milk price. Subdued outlook commentary despite the resilience of global dairy demand and strong start to FY21 is a timely reminder of the inherent volatility in FSF's earnings and various dynamics outside of its control (including supply and demand dynamics globally). The co-op has made solid progress following its strategic reset, however, there is still more work ahead to reach EPS targets and levels achieved previously. FSF is committed to medium term target EPS of 50cps (in FY24E), which is ahead of our expectations.

NZX Code	FSF
Share price	NZ$5.08
Issued shares	1612.1m
Market cap	NZ$8,189m
Avg daily turnover	167.1k (NZ$684k)

Financials: Jul/	20A	21E	22E	23E
NPAT* (NZ$m)	382.0	470.2	527.3	582.8
EPS* (NZc)	23.7	29.2	32.7	36.2
EPS growth* (%)	42.0	23.1	12.1	10.5
DPS (NZc)	5.0	12.0	14.0	17.0
Imputation (%)	100	100	100	100

*Based on normalised profits

Valuation (x)	20A	21E	22E	23E
PE	21.4	17.4	15.5	14.1
EV/EBIT	15.7	15.5	14.3	13.6
EV/EBITDA	9.1	8.9	8.4	8.1
Price / NTA	1.6	1.5	1.4	1.3
Cash div yld (%)	1.0	2.4	2.8	3.3
Gross div yld (%)	1.4	3.3	3.8	4.6

- **Earnings revisions:** Minor changes to near term earnings forecasts, with FY21E slightly below the midpoint of FSF's guidance. We materially lower our dividend forecasts (FY21E/22E/23E down -8%/-13%/-6%).

Strong 1H21 result; led by Greater China

FSF reported a strong 1H21 result (EPS of 25cps, +41% YoY), ahead of our expectations, with weakness in its core Ingredients segment more than offset by strong growth in its Foodservice and Consumer segments.

- **Ingredients** segment was soft (EBIT of NZ$288m, -23%) driven by lower volumes in Rest of World, and lower pricing
- **Foodservice** was the standout performer (EBIT of NZ$258m, +80%), led by Greater China, as sales volume increased for higher value products — benefitting from China's robust economy and government endorsement of dairy consumption
- After a very weak 2H20, **Consumer** has recovered strongly (EBIT of NZ$184m, +56%) with market share gains in both Australia and Chile supported by increased demand, helped by COVID-19 lockdown related tailwinds.

Earnings guidance retained; rising milk prices will weigh on margins

Despite the strong start to FY21 (EPS of 25cps), FSF maintained its EPS guidance range of NZ 25–35cps. The co-op is tracking well but global dairy prices have increased materially (~+35%) since September 2020, with Whole Milk Powder (WMP), the largest input in FSF's Farm Gate Milk Price (FGMP) rising at a similar rate. The shift in global dairy prices coupled with relatively subdued stream returns through FY21 to date will weigh heavily on margins in 2H21.

Balance sheet progress continues; approaching the end of the road

FSF has made good progress in repairing its balance sheet and reducing debt levels, helped by asset sales. Net debt was NZ$5,618m at 1H21, marginally below the prior year; this will lower further as it receives proceeds from its China Farms sale (~NZ$555m), likely in 2H21. FSF is committed to a medium-term gearing target of 2.5–3x net debt to EBITDA, which aligns with our forecasts. The co-op is nearing the end of its strategic reset, with only the sale of its DPA Brazil business and Beingmate stake (currently at 2.82%) outstanding.

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Fonterra Shareholders' Fund (FSF)

Priced as at 17 Mar 2021 (NZ$) **5.08**

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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	21,705	21,047	20,233
Normalised EBITDA	**1,380**	**1,497**	**1,446**	**1,501**	**1,563**
Depreciation and amortisation	(561)	(627)	(611)	(622)	(636)
Normalised EBIT	**819**	**870**	**835**	**878**	**927**
Net interest	(418)	(304)	(247)	(219)	(199)
Associate income	25	(6)	0	0	0
Tax	(177)	(175)	(118)	(132)	(146)
Minority interests	(48)	(27)	0	0	0
Normalised NPAT	**269**	**382**	**470**	**527**	**583**
Abnormals/other	(829)	412	0	0	0
Reported NPAT	**(532)**	**824**	**470**	**527**	**583**
Normalised EPS (cps)	16.7	23.7	29.2	32.7	36.2
DPS (cps)	0	5.0	12.0	14.0	17.0

Growth Rates	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Revenue (%)	-1.6	0.8	7.0	-3.0	-3.9
EBITDA (%)	-4.6	8.5	-3.4	3.8	4.2
EBIT (%)	-9.2	6.2	-4.0	5.2	5.6
Normalised NPAT (%)	-38.7	42.0	23.1	12.1	10.5
Normalised EPS (%)	-38.7	42.0	23.1	12.1	10.5
Ordinary DPS (%)	-100.0	n/a	>100	16.7	21.4

Cash Flow (NZ$m)	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
EBITDA	**1,380**	**1,497**	**1,446**	**1,501**	**1,563**
Working capital change	136	(67)	(157)	(23)	22
Interest & tax paid	(595)	(502)	(386)	(371)	(363)
Other	0	0	0	0	0
Operating cash flow	**921**	**928**	**903**	**1,107**	**1,222**
Capital expenditure	(632)	(400)	(586)	(646)	(696)
(Acquisitions)/divestments	396	714	555	0	0
Other	0	0	0	0	0
Funding available/(required)	**685**	**1,242**	**872**	**461**	**526**
Dividends paid	(22)	(29)	(193)	(226)	(274)
Equity raised/(returned)	0	0	0	0	0
(Increase)/decrease in net debt	**663**	**1,213**	**679**	**235**	**252**

Balance Sheet (NZ$m)	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Working capital	1,441	1,508	1,665	1,688	1,666
Fixed assets	6,512	6,006	5,540	5,677	5,850
Intangibles	2,597	2,240	2,191	2,141	2,088
Right of use asset	0	569	558	546	536
Other assets	2,571	3,213	3,222	3,231	3,240
Total funds employed	**13,121**	**13,536**	**13,175**	**13,283**	**13,380**
Net debt/(cash)	6,020	4,680	4,087	3,930	3,749
Lease liability	0	604	559	523	492
Other liabilities	1,220	946	946	946	946
Shareholder's funds	5,881	7,333	7,610	7,911	8,220
Minority interests	0	(27)	(27)	(27)	(27)
Total funding sources	**13,121**	**13,536**	**13,175**	**13,283**	**13,380**

* 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)	10.2	9.1	8.9	8.4	8.1
EV/EBIT (x)	17.1	15.7	15.5	14.3	13.6
PE (x)	30.4	21.4	17.4	15.5	14.1
Price/NTA (x)	2.5	1.6	1.5	1.4	1.3
Free cash flow yield (%)	3.5	6.4	3.9	5.6	6.4
Net dividend yield (%)	0.0	1.0	2.4	2.8	3.3
Gross dividend yield (%)	0.0	1.4	3.3	3.8	4.6

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	5.8	6.8	7.9
Net debt/ND+E (%)	50.6	39.0	34.9	33.2	31.3
Net debt/EBITDA (x)	4.4	3.1	2.8	2.6	2.4

Key Ratios	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Return on assets (%)	4.8	4.9	4.8	5.0	5.3
Return on equity (%)	4.6	5.2	6.2	6.7	7.1
Return on funds employed (%)	5.2	5.8	6.1	6.4	6.6
EBITDA margin (%)	6.9	7.4	6.7	7.1	7.7
EBIT margin (%)	4.1	4.3	3.8	4.2	4.6
Capex to sales (%)	3.1	2.0	2.7	3.1	3.4
Capex to depreciation (%)	138	76	114	124	131
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	0	21	41	43	47

Operating Performance	**2019A**	**2020A**	**2021E**	**2022E**	**2023E**
Revenue (NZ$m)					
Ingredients	-	13,666	14,681	13,737	12,673
Consumer	-	3,985	4,157	4,247	4,340
Foodservice	-	2,631	2,867	3,063	3,220
Total revenue	**20,114**	**20,282**	**21,705**	**21,047**	**20,233**
Gross profit	**3,015**	**3,046**	**3,099**	**3,209**	**3,293**
Operating data					
Milk solids collected (KgMS, m)	1,523	1,516	1,525	1,525	1,525
FGMP (NZ$)	6.35	7.14	7.60	7.00	6.40
Cost breakdown					
Selling and marketing expense	(590)	(551)	(586)	(579)	(587)
Distribution expenses	(561)	(482)	(510)	(547)	(536)
Administrative expenses	(773)	(835)	(843)	(869)	(895)
Other operating expenses	(387)	(377)	(381)	(392)	(404)
Total operating expenses	**(2,311)**	**(2,245)**	**(2,320)**	**(2,387)**	**(2,422)**

Key charts and tables

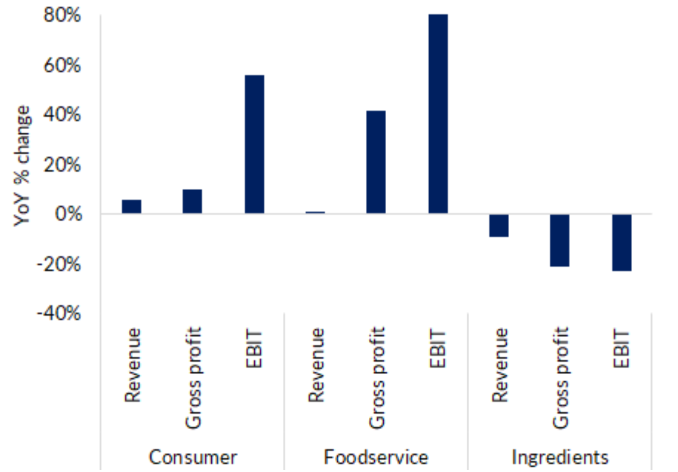
Figure 1. Earnings revisions (NZ$m)

	FY21E			FY22E			FY23E		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
Normalised EBIT	835	835	0%	876	878	0%	916	927	1%
Normalised NPAT	468	470	0%	521	527	1%	572	583	2%
Underlying EPS (cps)	**29.4**	**29.2**	**-1%**	**32.7**	**32.7**	**0%**	**35.9**	**36.2**	**1%**
Dividend (cps)	13.0	12.0	-8%	16.0	14.0	-13%	18.0	17.0	-6%

Source: Forsyth Barr analysis

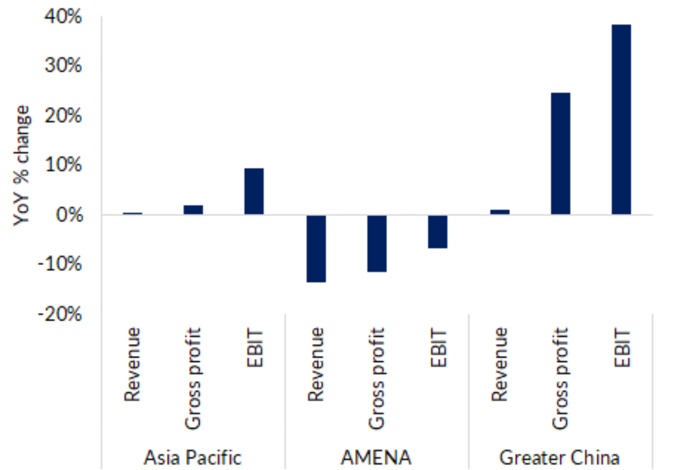
Charts of interest

Figure 2. Foodservice the standout performer...



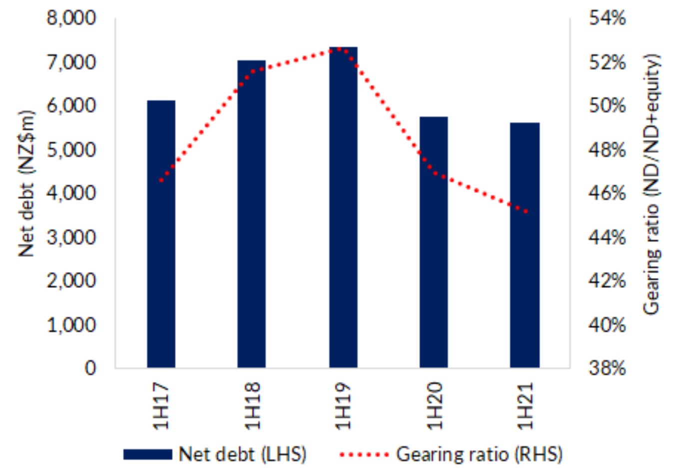
Source: Forsyth Barr analysis, Company reports

Figure 3. ...driven by Greater China



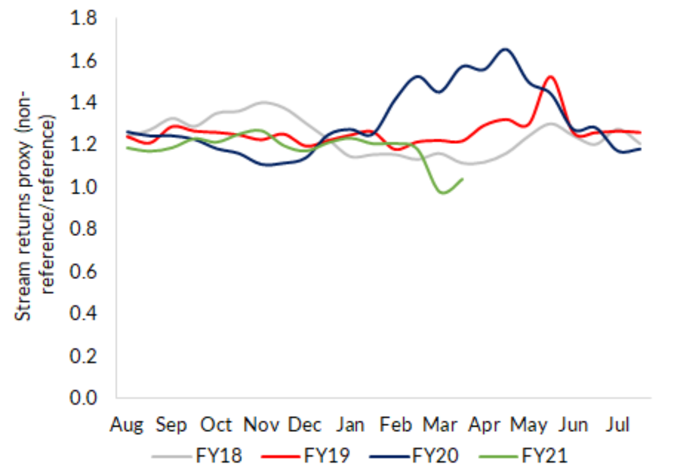
Source: Forsyth Barr analysis, Company reports

Figure 4. Balance sheet pressure alleviating



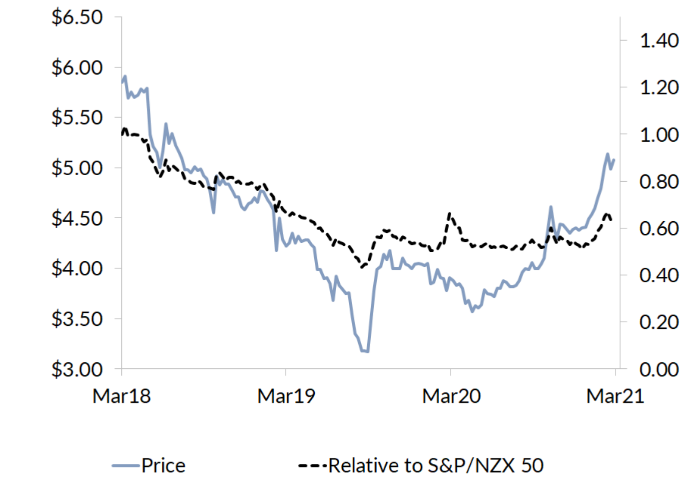
Source: Forsyth Barr analysis, Company reports

Figure 5. FY21 stream returns to date materially below FY20



Source: Forsyth Barr analysis, GDT auctions

Figure 6. Price performance



Source: Forsyth Barr analysis

Figure 7. Substantial shareholders

Shareholder	Latest Holding
FSF Management Company	6.9%

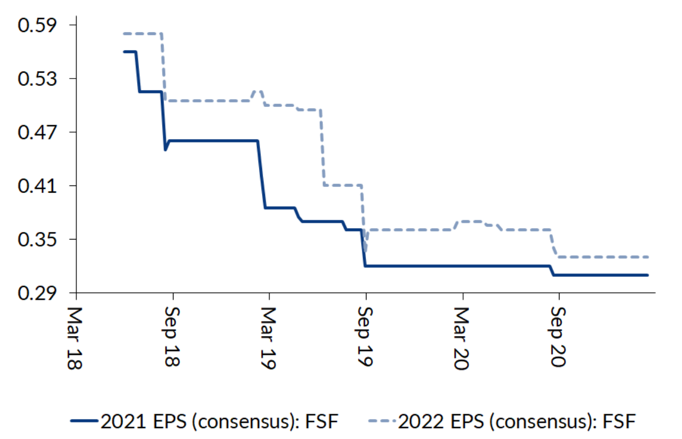
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

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)	2021E	2022E	2021E	2022E	2021E	2022E	2022E
Fonterra	**FSF NZ**	**NZ$5.08**	**NZ$8,189**	**17.4x**	**15.5x**	**8.9x**	**8.6x**	**15.4x**	**14.7x**	**2.8%**
DANONE	BN FP	€59.84	€41,088	18.9x	17.1x	12.3x	11.7x	17.3x	15.3x	3.5%
NESTLE SA-REG	NESN SW	CHF101.38	CHF292,076	23.3x	22.3x	17.4x	16.8x	21.5x	20.9x	2.9%
SAPUTO INC	SAP CN	C$38.32	C$15,748	21.7x	19.0x	12.3x	11.2x	18.3x	15.8x	n/a
BEGA CHEESE	BGA AT	A$6.29	A$1,902	37.1x	20.6x	12.4x	7.5x	22.3x	11.9x	2.3%
KERRY GROUP PLC-A	KYG ID	€101.90	€18,008	29.0x	25.0x	19.9x	17.6x	26.1x	23.4x	1.0%
INNER MONGOLIA YILI INDUS-A	600887 CH	CN¥39.59	CN¥240,811	29.9x	25.6x	19.5x	16.7x	24.8x	21.4x	2.6%
CHINA MENGNIU DAIRY CO	2319 HK	CN¥45.75	CN¥180,630	42.2x	31.6x	26.0x	20.4x	39.0x	28.2x	0.7%
			Compco Average:	**28.9x**	**23.0x**	**17.1x**	**14.6x**	**24.2x**	**19.5x**	**2.2%**
EV = Current Market Cap + Actual Net Debt			**FSF Relative:**	**-40%**	**-33%**	**-48%**	**-41%**	**-36%**	**-25%**	**27%**

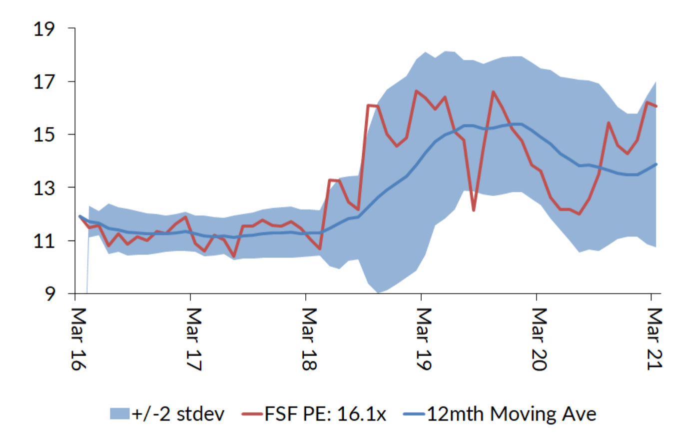
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (FSF) companies fiscal year end

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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