

# Market Announcement

23 MAY 2019

## Fonterra provides strategy, milk price and earnings updates

- Key third-quarter financial performance numbers:
  - Sales volumes: 16.6 billion LME, up 4%
  - Revenue: \$15 billion, up 1%
  - Gross margin: \$2.2 billion, down 3%
  - Normalised operating expenses: \$1.8 billion, down \$73 million
  - Normalised EBIT: \$522 million, down 9%
  - Capital expenditure: \$419 million, down 28%
- Revised forecast earnings per share range: 10-15 cents from 15-25 cents per share
- 2018/19 forecast Farmgate Milk Price range: \$6.30 - \$6.40 per kgMS
- Opening 2019/20 forecast Farmgate Milk Price range: \$6.25 - \$7.25 per kgMS
- 2019/20 Advance Rate Schedule has been set off \$6.75 per kgMS

Fonterra Co-operative Group Limited today gave an update on its strategy review and shared timeframes for turning around the Co-op's performance. At the same time, it announced its third-quarter business update, revised forecast earnings range, narrowed the range for its 2018/19 forecast Farmgate Milk Price, and gave an opening forecast Farmgate Milk Price range for the 2019/20 season.

Fonterra Chief Executive Miles Hurrell said that good progress is being made on the strategy review and reiterated that the benefits from those changes will take time to flow through into the Co-op's financial performance.

"I appreciate that our farmers and unit holders want clarity on our new strategy and expect a decent return on their investment.

"We're on-track to share our new strategy in September. In the meantime, we're getting on and making decisions to reduce complexity and simplify our business so we can focus on where we have competitive advantages.

"Farmers and unit holders can expect to see some fluctuation in our earnings over the next couple of years and there will be one-off transactions and adjustments (some positive, some negative) as we reset the business and deliver on our new strategy.

"We are committed to keeping people updated as we make progress. Today's update is:

- We are commencing a strategic review of our two wholly-owned farm-hubs in China
- We have agreed with our partner Nestle to review options for the future ownership of our Dairy Partners Americas (DPA) Brazil joint venture, including a potential sale of respective stakes
- We are closing our Dennington site in Australia.

"These decisions relate to our new strategic direction – in particular, prioritising our New Zealand milk supply and simplifying our global portfolio, which, as we have said previously, requires us to review every part of business to ensure it meets the needs of the Co-op today."

Commenting on the strategic review of its China farms, Mr Hurrell said China remains a key market for Fonterra.

“We have contributed to China’s dairy industry by developing high quality model farms and showing there is a valuable opportunity for fresh milk in China’s consumer market, and this continues to be an attractive prospect.

“However, this does not necessarily mean that we need to continue to have large amounts of capital tied up in farming hubs.

“On DPA Brazil, which is a joint venture distributing chilled dairy products throughout Brazil, the review into future ownership options and whether to sell is expected to be completed by the end of 2019,” said Mr Hurrell.

“Yesterday, we also started talking to the team at our Dennington factory in Australia about the tough call we’re making to close the site. The Australian Ingredients business continues to feel the impact of the drought and other significant changes that mean there is excess manufacturing capacity in the Australian dairy industry.

“This is not a one-off for this season, it’s the new norm for the Australian dairy industry and we need to adapt. We need to get the most value from every drop of our farmers’ milk and, with the reduced milk pool in Australia, we must put it into our highest returning products and most efficient assets. Dennington is over 100 years old and not viable in a low-milk pool environment.

“We have 98 employees at Dennington and this decision will be incredibly hard for them. Our top priority is to support our people.”

### **Business performance and revised earnings guidance**

Fonterra’s revenue for the nine months to 30 April 2019 was \$15 billion, up 1% on the same period last year, and sales volumes were 16.6 billion liquid milk equivalent (LME), up 4%. However, normalised EBIT was down 9% to \$522 million.

In Ingredients, sales volumes for the first nine months were up 10% to 16.3 billion LME, gross margin was down to 8.6% from 9.6% and EBIT was down \$64 million to \$602 million.

In Consumer and Foodservice sales volumes were down 1% to 3.8 billion LME, gross margin was down to 22.8% from 23.6% and normalised EBIT was down \$62 million to \$266 million.

Fonterra Chief Executive Miles Hurrell said the New Zealand Ingredients business is performing as expected but Australia Ingredients continues to face challenges and it is taking longer than planned to lift performance in some parts of the Co-op’s Consumer and Foodservice business.

“Due to the challenges in Australia Ingredients and tightening relative price differences between reference products, or those products that inform the Farmgate Milk Price, and non-reference products – that’s all our other products, we are reducing the forecast full year normalised EBIT for the whole Ingredients business to \$645 - \$725 million, down from the \$750 - \$850 million range we shared at our Interim Results.

“Consumer and Foodservice improved its performance in the third quarter relative to the first half. Due to our performance in Latin America we have lowered our forecast normalised EBIT from \$475 - \$525 million to \$400 - \$430 million for this part of the Co-op.

“Our China Foodservice recovered as demand for butter bounced back. This helped pricing and in-market inventory return to more normal levels. There was good demand for Anchor Food Professionals UHT culinary cream and the team at our Waitoa UHT factory have been working hard to get shipments up to our China foodservice customers.

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“Our Oceania Consumer and Foodservice business continued to perform well with Australia’s spreads category, including Western Star butter, contributing significantly to gross margin.”

Mr Hurrell said that there are some increased risks in the fourth quarter to the Co-op’s previous forecast earnings – in particular, the recovery in key markets is slower than expected and there are tightening price relativities between non-reference and reference products along with the on-going challenges in Australia Ingredients.

As a result, Fonterra is revising its earnings guidance range from 15 - 25 cents per share to 10 - 15 cents per share.

**2019/20 opening season forecast Farmgate Milk Price and updated 2018/19 forecast Farmgate Milk Price range.**

Chairman John Monaghan said, as farmers get ready to start the new season on 1 June, the forecast 2019/20 Farmgate Milk Price range will be \$6.25 - \$7.25 per kgMS.

“This is a realistic opening forecast. We are having to look out more than a year into the future which is difficult, but what the information available is continuing to show us is that demand remains strong across key trading partners and this is reflected in GDT prices.

“We are giving farmers a wide range for the opening forecast milk price. It will be narrowed as the season goes on. The 2019/20 Advance Rate Schedule has been set off \$6.75 per kgMS.

“Weather plays a significant role in determining global milk volumes, and therefore price. We are forecasting our New Zealand collections to be 1,520 million kgMS for the new season, which is up slightly on the current season. There’s still a lot of water to go under the bridge before we’ll have a clear view of what the season holds for both our Co-op’s production and global dairy supply.”

Fonterra has also narrowed its 2018/19 forecast Farmgate Milk Price range from \$6.30 - \$6.60 per kgMS range by 20 cents to \$6.30 - \$6.40per kgMS.

This reflects favourable foreign exchange movements but slightly weaker than expected pricing for whole milk powder and skim milk powder.

The Co-op has now contracted the majority of its farmers’ milk for the current season and has greater certainty on the likely closing Farmgate Milk Price. This is also reflected in the tighter forecast range.

-ENDS-

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Dairy for life

# Business Update

MAY 2019





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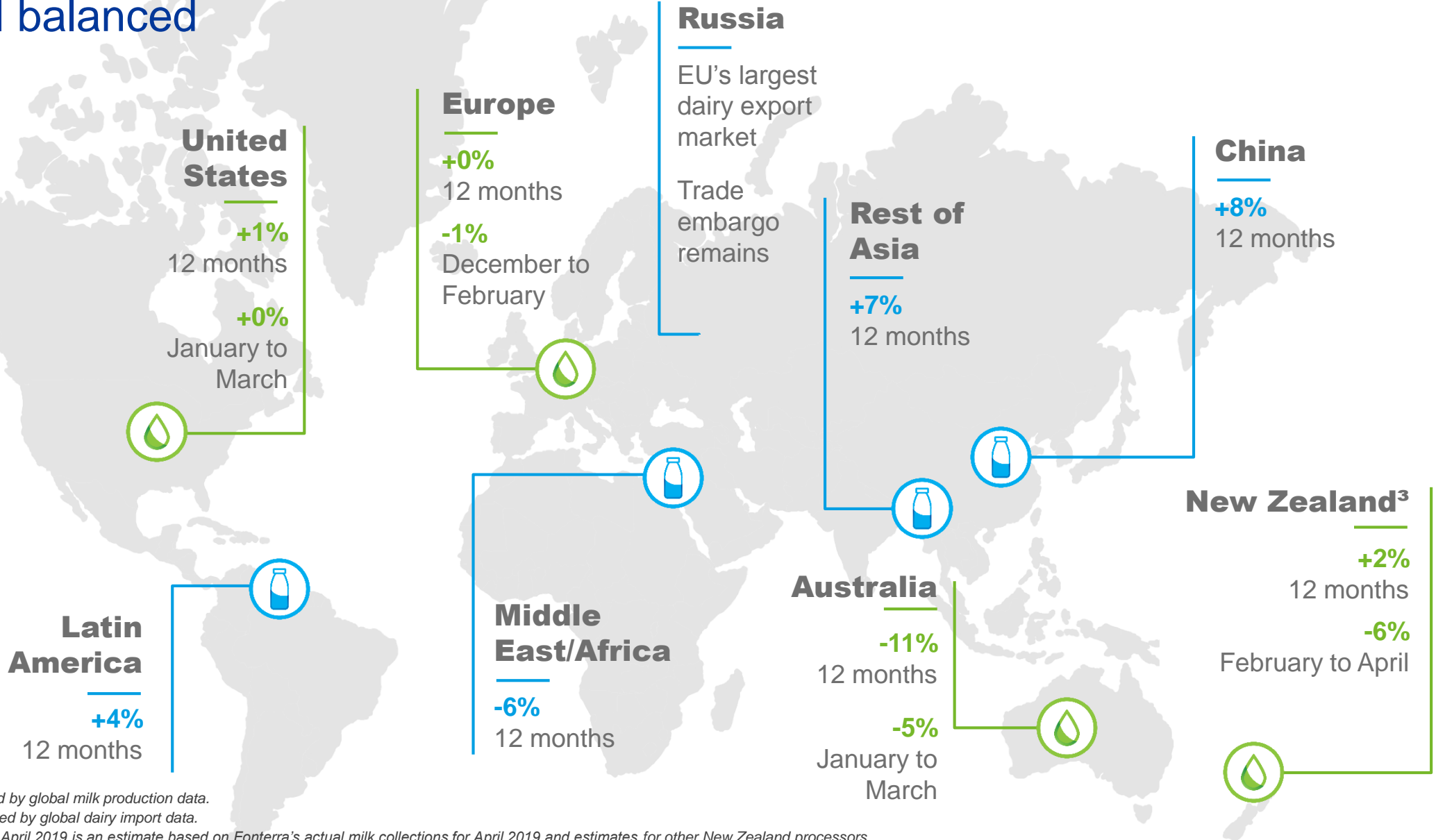
# Business update summary

- Strategic review progressing well and on-track to share full details at Annual Results. Further initiatives announced today as we reduce complexity and simplify portfolio to focus on competitive advantages
- Strategy reset and business turnaround will take time. Expecting a number of one-off transactions and adjustments (some positive, some negative) as we implement the new strategy
- Delivering on three-point plan
  - Tip Top sold for \$380 million
  - Reduction in normalised operating expenses on-track, \$73 million reduction versus last year
  - Capital expenditure on-track to be \$200 million lower than last year
- In Q3 some progress in business performance – in particular, Consumer and Foodservice – but some areas taking longer, placing increased risk to earnings in last quarter. Full-year earnings guidance revised to 10 – 15 cents earnings per share
- 2019/20 Forecast Farmgate Milk Price opening range of \$6.25-\$7.25 per kgMS
- 2018/19 Forecast Farmgate Milk Price range narrowed to \$6.30-\$6.40 per kgMS and milk collections held at 1,510m kgMS

# Strong outlook with global dairy market well balanced

**Global Supply<sup>1</sup>**

**Global Demand<sup>2</sup>**



1. Global Supply is represented by global milk production data.

2. Global Demand is represented by global dairy import data.

3. New Zealand production for April 2019 is an estimate based on Fonterra's actual milk collections for April 2019 and estimates for other New Zealand processors.

Note: All 12-month figures are rolling 12 months compared to previous comparable period: Australia (Mar), EU (Feb), United States (Mar), China (Mar), Asia (Feb), Middle East & Africa (Jan), Latin America (Feb), New Zealand (April).

Source: Government milk production statistics; GTIS trade data; Fonterra analysis.

# Unaudited FY19 nine-month business performance<sup>1</sup>

Some progress in Q3 but it is taking longer than planned to lift performance in some areas

Volume LME	Revenue	Gross Margin	Normalised Opex	Normalised EBIT <sup>2</sup>	Reported EBIT	Capex
16.6bn	\$15.0bn	\$2.2bn	\$1.8bn	\$522m	\$386m	\$419m
4%	1%	\$79m	\$73m	9%	723%	28%

## Ingredients

Volume LME <sup>3</sup>	Gross Margin	EBIT
16.3b  10%	\$1.1b  \$44m	\$602m  \$64m
8.6%  from 9.6%		

## Consumer & Foodservice

Volume LME <sup>3</sup>	Gross Margin	EBIT <sup>2</sup>
3.8b  1%	\$1.2b  \$45m	\$266m  \$62m
22.8%  from 23.6%		

## China Farms<sup>4</sup> (End to End)

Volume LME <sup>3</sup>	Gross Margin	EBIT
192m  3%	\$(13)m  \$14m	\$(23)m  \$11m
(7.0)%  from (15.1)%		

1. The third quarter numbers have not been audited.

2. Includes normalisation adjustment of \$136 million for the Venezuela divestment and professional fees related to ongoing strategic portfolio review.

3. Includes inter-segment sales.

4. Provides end-to-end perspective, comprising China Farm segment plus financials from Ingredients and Consumer and Foodservice related to China Farms.

Note: All changes are expressed relative to the nine-month performance of FY18.



# Full-year earnings guidance revised to 10–15 cents earnings per share

Lower segment EBIT partially offset by greater savings in unallocated Group costs

Forecast EPS<sup>1</sup>

**10-15**  
cents

Forecast 2019 Farmgate Milk Price

**\$6.30 - \$6.40**  
kgMS

Forecast 2019 Milk Collections

**1,510**  
million kgMS

**INGREDIENTS**

Revised Forecast Gross Margin

**8% - 9%**

Revised Forecast EBIT

**\$645 - \$725** million

**CONSUMER AND FOODSERVICE**

Revised Forecast Gross Margin

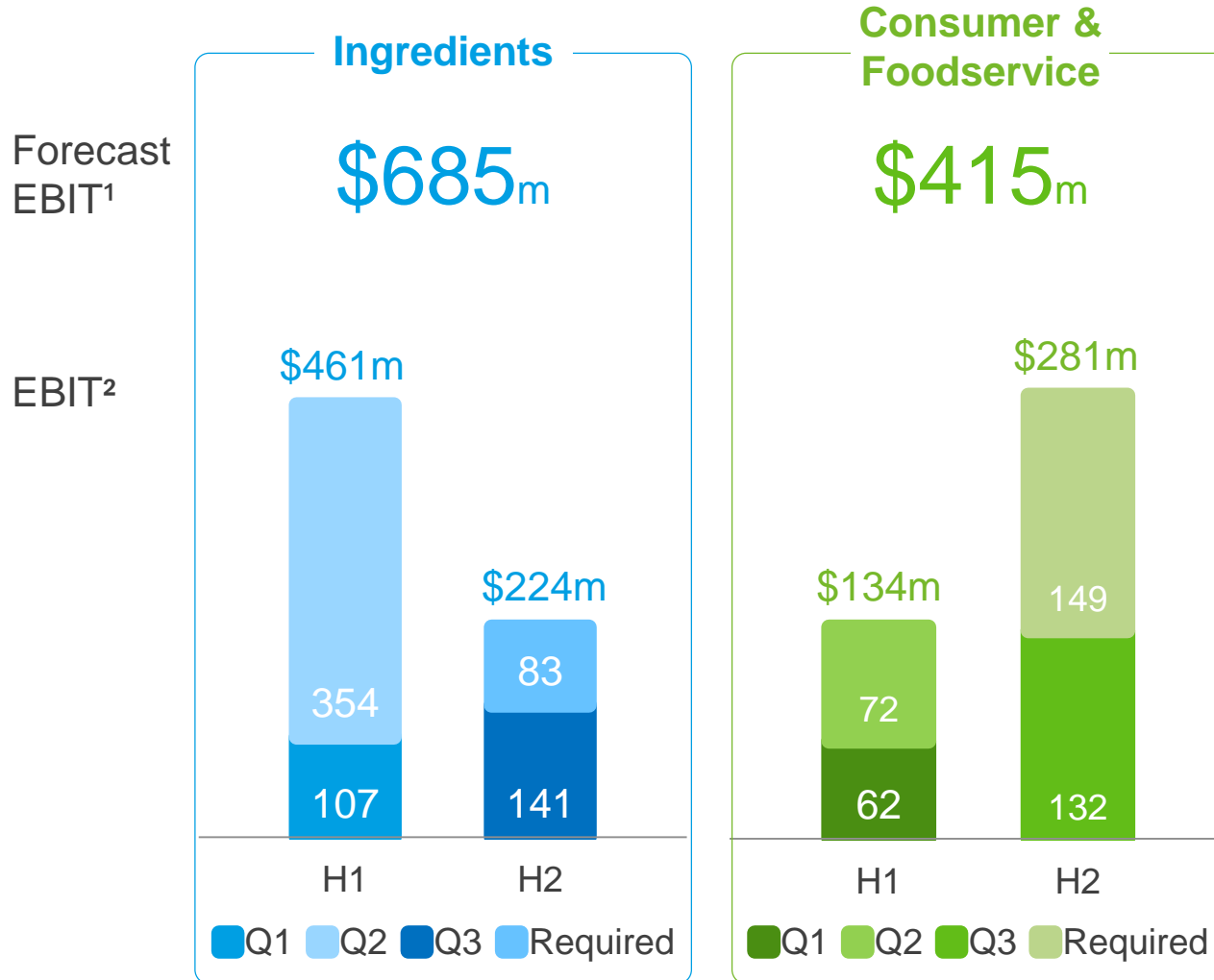
**23% - 24%**

Revised Forecast EBIT

**\$400 - \$430** million

1. Earnings per share.

# What we need to do in the last quarter to meet the mid-point of earnings guidance



## Ingredients

- \$83 million Q4 EBIT:
  - Similar volumes as Q3 and Q4 gross margin of at least 6.5%. Year-to-date gross margin is 8.6%
  - Continued reduction of operating costs in Australia
- Risks:
  - Tightening of price relativities between non-reference and reference
  - Pricing lags on long-term sale agreements

## Consumer and Foodservice

- \$149 million Q4 EBIT:
  - Gross margin of 23% on similar volumes to Q3
  - 2017 and 2018 Q4 EBIT was \$143 million and \$196 million, respectively
- Risks:
  - Recovery in key markets slower than expected
  - Recent increase in fat prices narrowing Foodservice margin

1. Mid-point of the forecast EBIT range that equates to the mid point of the EPS guidance of 10-15 cents per share.

2. Q1, Q2 and Q3 represent actual normalised EBIT. 'Required' is the amount required in Q4 to achieve the mid-point of the full-year earnings guidance range.

# Delivering on three-point plan

Tangible benefits starting to flow through

## Take Stock

- Reduce debt by \$800 million
- Gearing within 40-45% range by year-end

- Tip Top sold for \$380 million with a gain over book value of \$100 million
- Received good interest from potential buyers for DFE Pharma
- Continuing to review options for our shareholding in Beingmate
- Full-year gearing target requires previously announced asset divestments

## Getting the basics right

- Reduce capex to \$650 million in FY19
- Reduce opex back to FY17 levels over the next two years

- Capital expenditure on-track to be \$200 million lower than last year
- Well on-track, \$73 million reduction in normalised operating expenses versus last year

## More accurate forecasting

- Improved disclosures to deal with forecast volatility
- Introduced quarterly EBIT disclosure

# Full strategy review well underway to fundamentally reset the Co-op

Looking at all aspects of our business

## Strategic review – Update

- On-track to announce full details of new strategy at 2019 Annual Results
- Reducing complexity and increasing focus on our competitive advantages to deliver growth
- The strategy review is resulting in decisions
  - Strategic review of our two wholly-owned farm hubs in China
  - Agreed with JV partner Nestlé to review the ownership of Dairy Partners Americas (DPA) Brazil joint venture
  - Closure of Dennington – a nutritional site in Australia – as a result of the lower milk production and changing dynamics of the Australian dairy industry

## Timeline



Strategy Review kicked-off in January



Progress updates (Interim Results, MyConnect conference in May and Q3 business update)



Full strategy announced at 2019 Annual Results





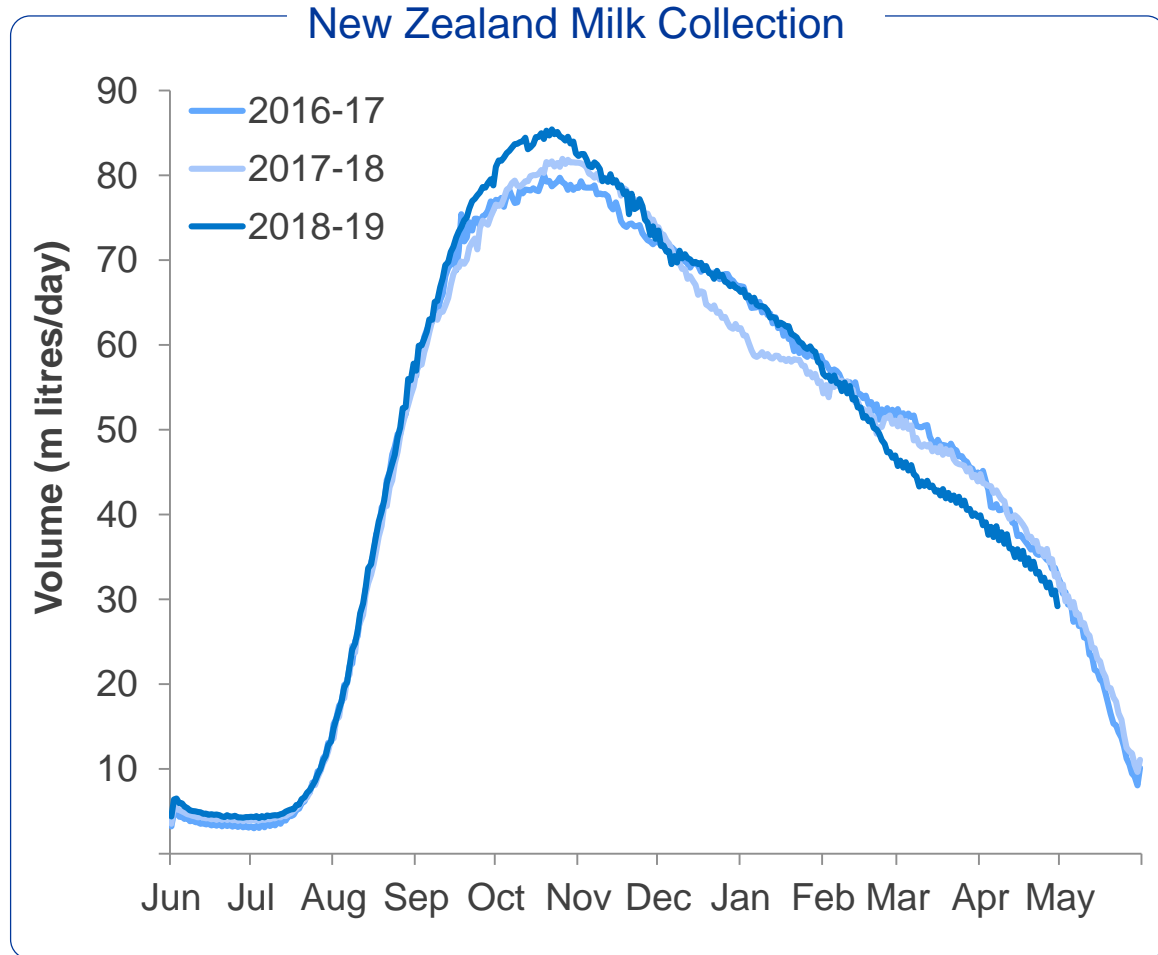
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## **APPENDIX**

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# Milk collections forecast for season maintained



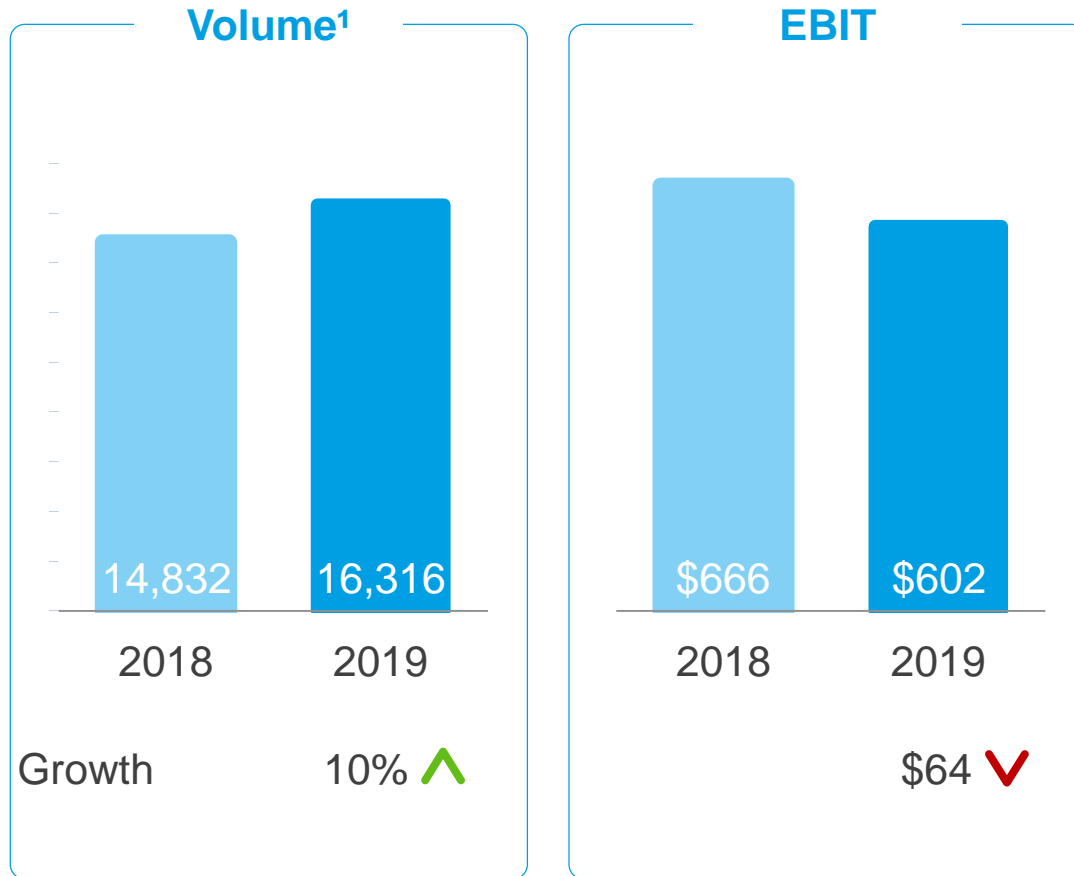
- Collections to the end of April reached 1,454 million kgMS, up 1%, largely due to favourable spring conditions
- Gains in first half of season were significantly offset by lower collections during Q3 period
  - Down 2%, 9% and 9% for February, March and April respectively
- On-farm conditions have improved but nearing end of season may only have limited impact on milk production

Season	Total Milk Solids (kgMS)	Peak Day Milk
2016/17	1,526m (down 3%)	80m litres
2017/18	1,505m (down 1%)	82m litres
2018/19F	1,510m (up 0.3%)	85m litres



# Ingredients

New Zealand performed to expectations but Australia continues to face challenges



## Performance

- New Zealand continues steady performance
  - Pressure on gross margin from price relativities between non-reference and reference
  - Softer gross margin percentage offset by higher volume compared to prior year
- Australia performance unsatisfactory but delivering on cost savings
  - Low milk volumes impacting fixed cost recoveries
  - Insufficient volume of higher gross margin nutritional products
- Prolesur continues to underperform due to low milk collections and increased cost of milk

1. Includes sales to other strategic platforms.

Note: Volume is in million LME. EBIT is in NZD millions unless otherwise stated. All changes are expressed relative to the nine-month performance of FY18.



# New Zealand Ingredients product mix

	Q3 FY18	Q4 FY18	Q1 FY19	Q2 FY19	Q3 FY19 <sup>2</sup>	Change Q3 FY18 to Q3 FY19
<b>Production Volume (000 MT)</b>						
Reference	481	103	633	713	440	(9)%
Non-Reference	208	70	227	258	210	1%
<b>Sales Volume (000 MT)</b>						
Reference	455	439	247	678	535	18%
Non-Reference <sup>1</sup>	168	210	159	230	233	39%
<b>Revenue (\$ per MT)</b>						
Reference	4,636	5,214	5,257	4,439	4,539	(2)%
Non-Reference <sup>1</sup>	5,555	5,764	5,405	5,469	5,238	(6)%

1. Includes bulk liquid milk.

2. The way in which Ingredients presents certain inter-segment sales between Ingredients and Foodservice was revised in FY19. This increased sales volumes for Q3 FY19 by 9,000 MT and 45,000 MT on reference and non-reference products respectively, and increased sales revenue by \$56 million and \$175 million on reference and non-reference products respectively. This change had no impact to the reported gross margin for the Ingredients business.

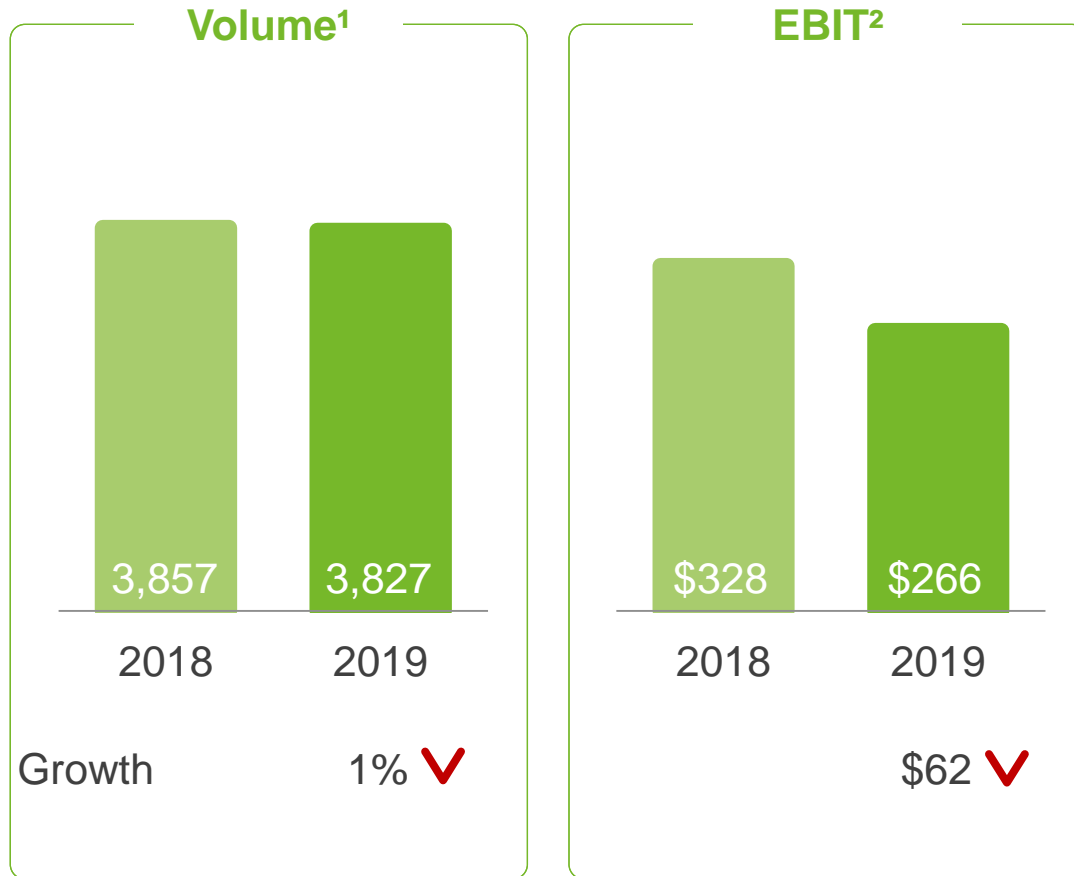
Note: Reference products are products used in the calculation of the Farmgate Milk Price – WMP, SMP, BMP, Butter and AMF.





# Consumer and Foodservice

Stronger Q3 performance relative to first half, driven by Greater China Foodservice



## Performance

- Foodservice sales volume and earnings improved in Q3 as Mainland China market stabilised
- Consumer sales volumes slower to recover due to sales conditions in Asia, improved towards end of Q3
- Continued solid performance in Oceania, volume growth in both Consumer and Foodservice
- Q3 Earnings improvement in Latin America relative to H1 but not as much as planned

1. Includes sales to other strategic platforms.

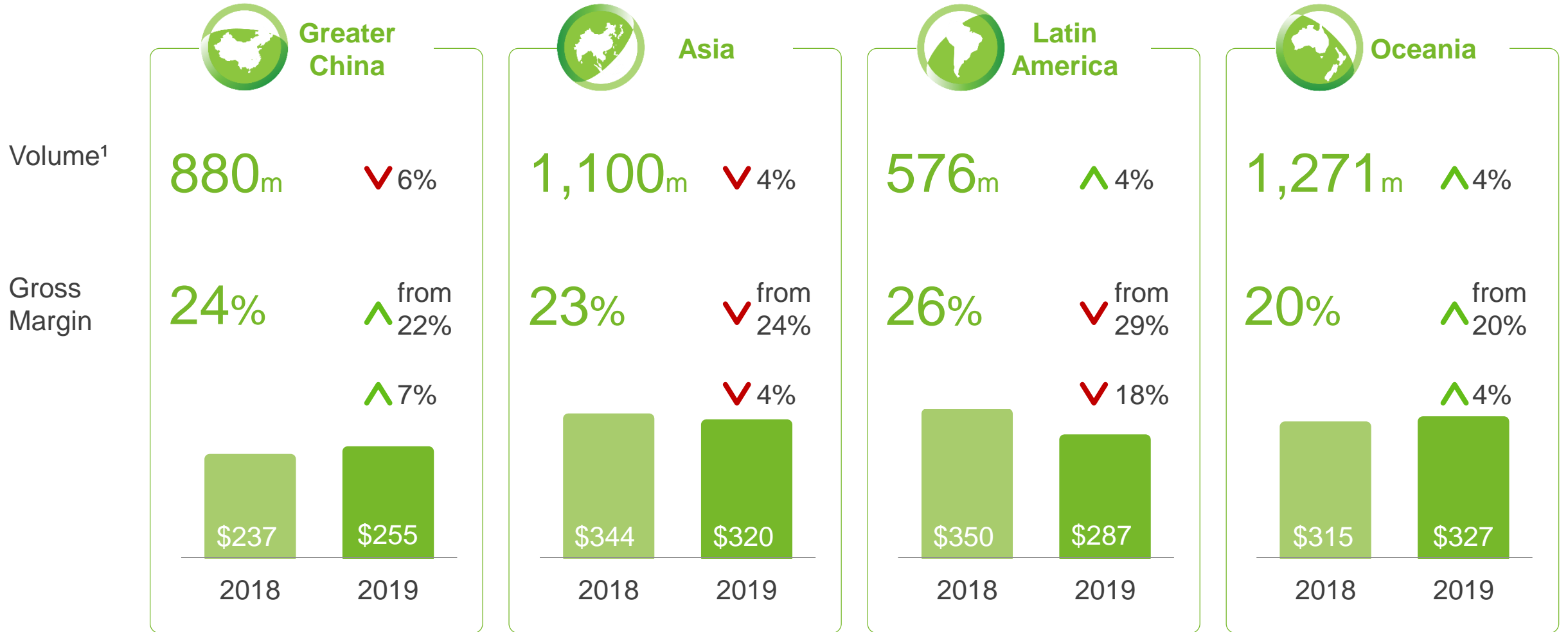
2. Includes normalisation adjustment of \$136 million for the Venezuela divestment and professional fees related to ongoing strategic portfolio review.

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# Consumer and Foodservice by region

Solid performance in Oceania, stronger Q3 for Greater China lifted its year-to-date performance



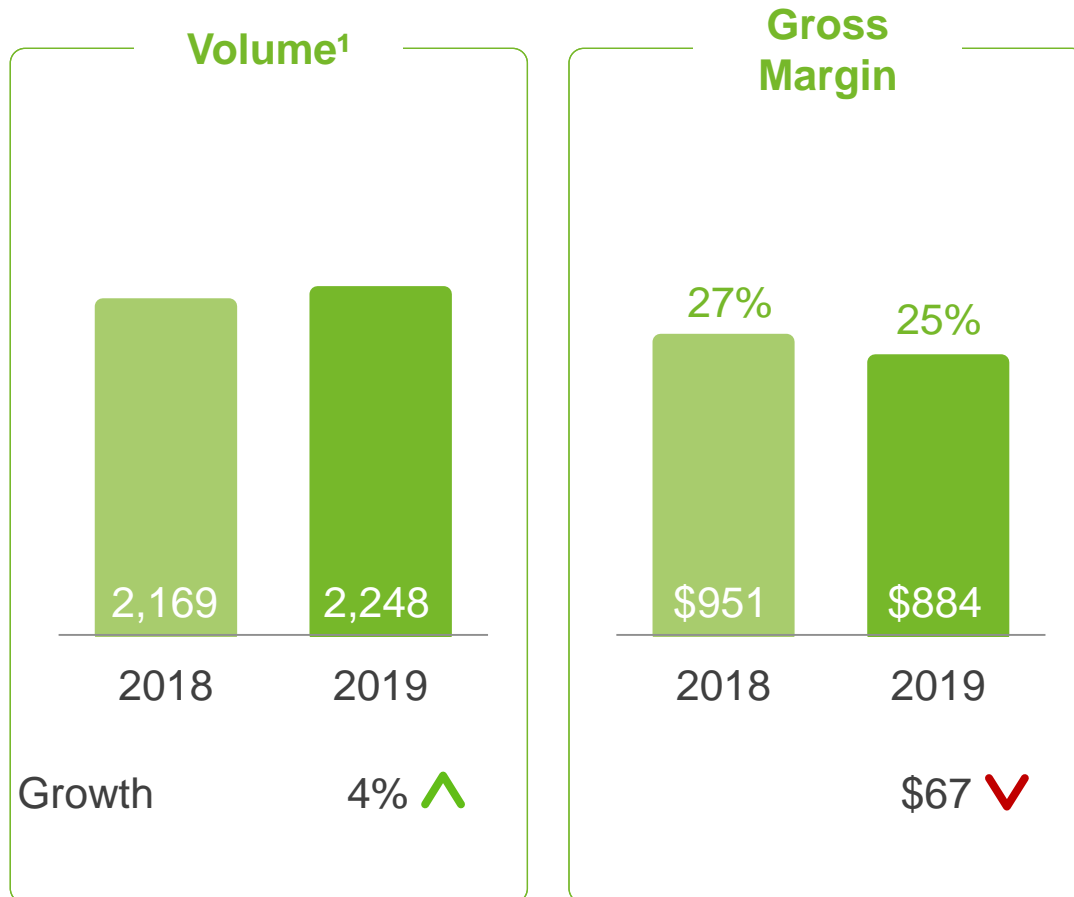
1. Includes sales to other strategic platforms.

Note: Volume is in million LME. Gross margin is in NZD millions unless otherwise stated. All changes are expressed relative to the nine-month performance of FY18.



## Consumer

Latin America performance improving but recovery slower than expected



### Performance

- Asia volume down as decision to protect margins in some markets
  - Sales volume returned to more normal levels in April
- Mainland China gross margin continued to improve due to Anmum business model change
- Latin America performance has improved in Q3 but recovery slower than expected
  - Soprole and Brazil, gross margin recovering and improved operational efficiency
  - Continued economic challenges in Venezuela, exited business in March
- Solid performance in Oceania, in particular spreads category in Australia continues to perform strongly

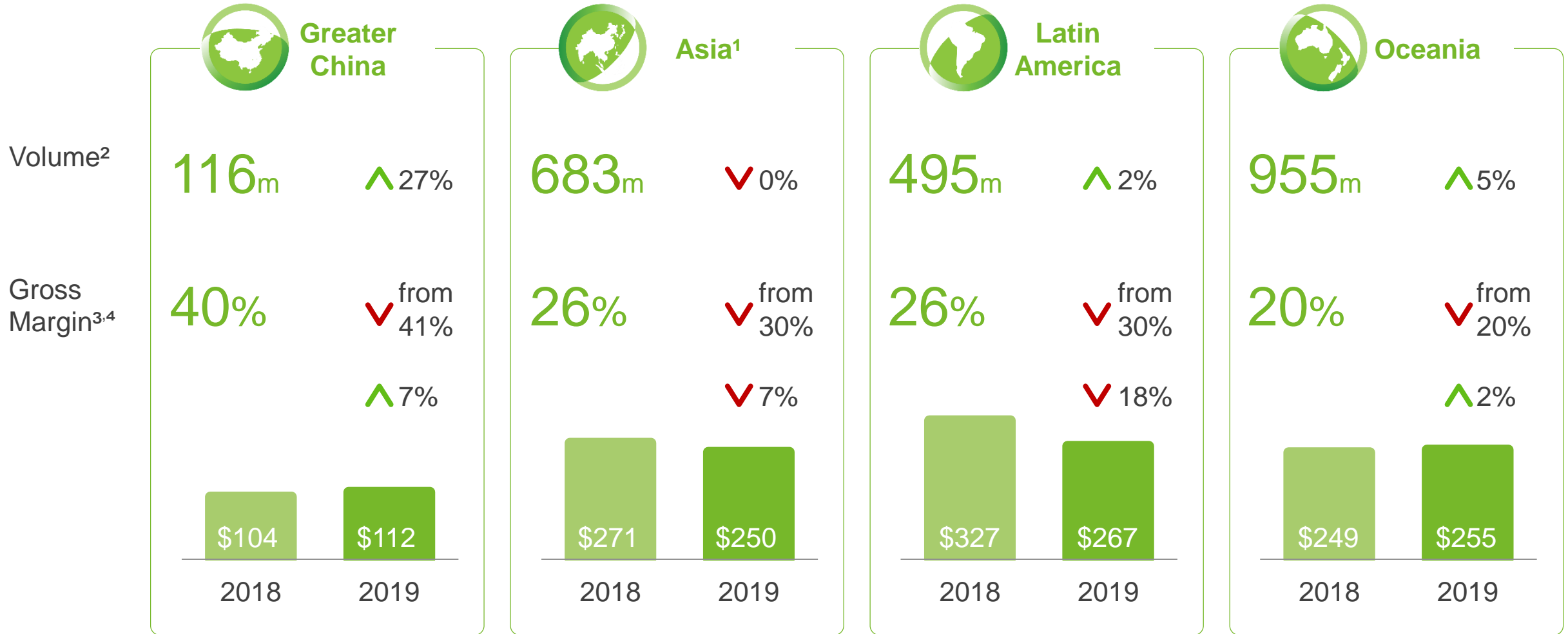
1. Includes sales to other strategic platforms.

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# Consumer

Gross margin percentage down, more than offset in Greater China and Oceania by volume growth



1. FY18 LME volume has been adjusted for the inclusion of eliminating entries to improve comparability.

2. Includes sales to other strategic platforms.

3. Sum of individual numbers from the regional and divisional breakdown may not add to the totals in each category due to rounding.

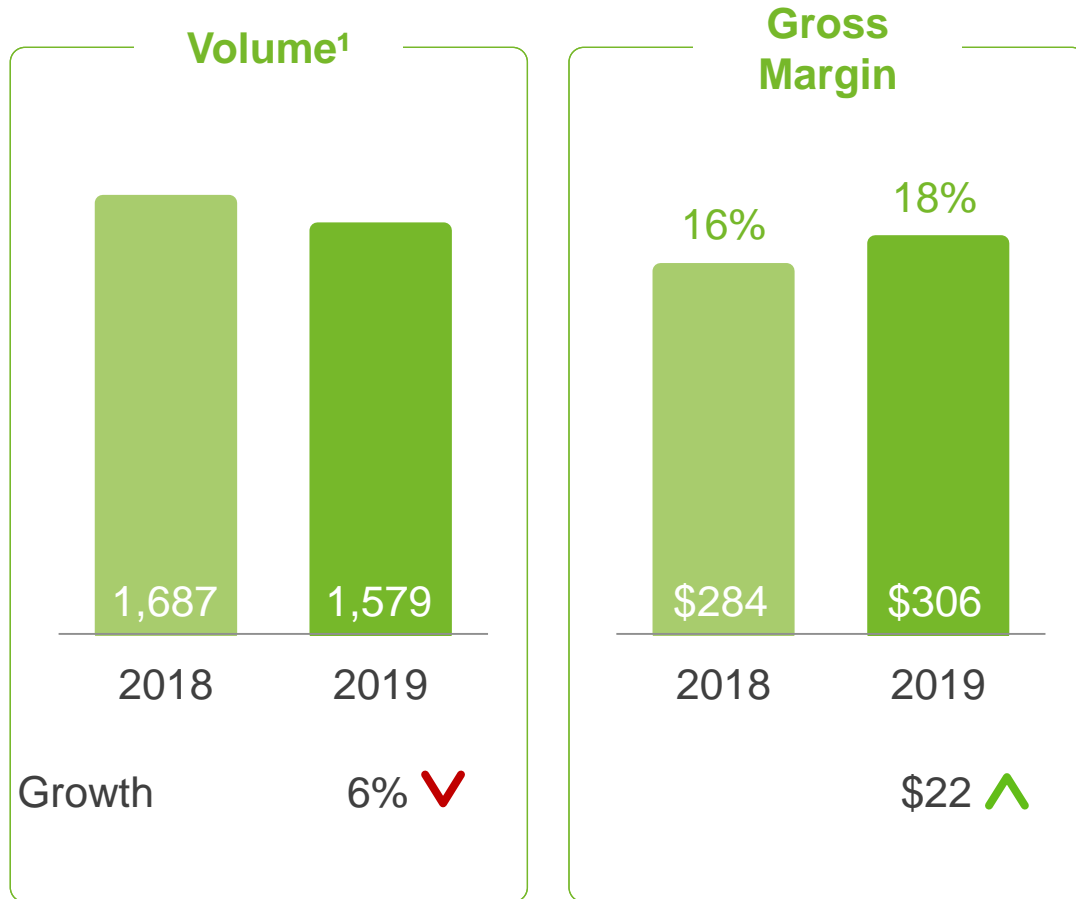
4. Percentages as shown in tables may not align to the calculation of percentages

based on numbers in the tables due to rounding of reported figures. Note: Volume is in million LME. Gross margin is in NZD millions unless otherwise stated. All changes are expressed relative to the nine-month performance of FY18.



# Foodservice

Gross margin percentage growth driven by Q3 performance in Greater China and Asia



## Performance

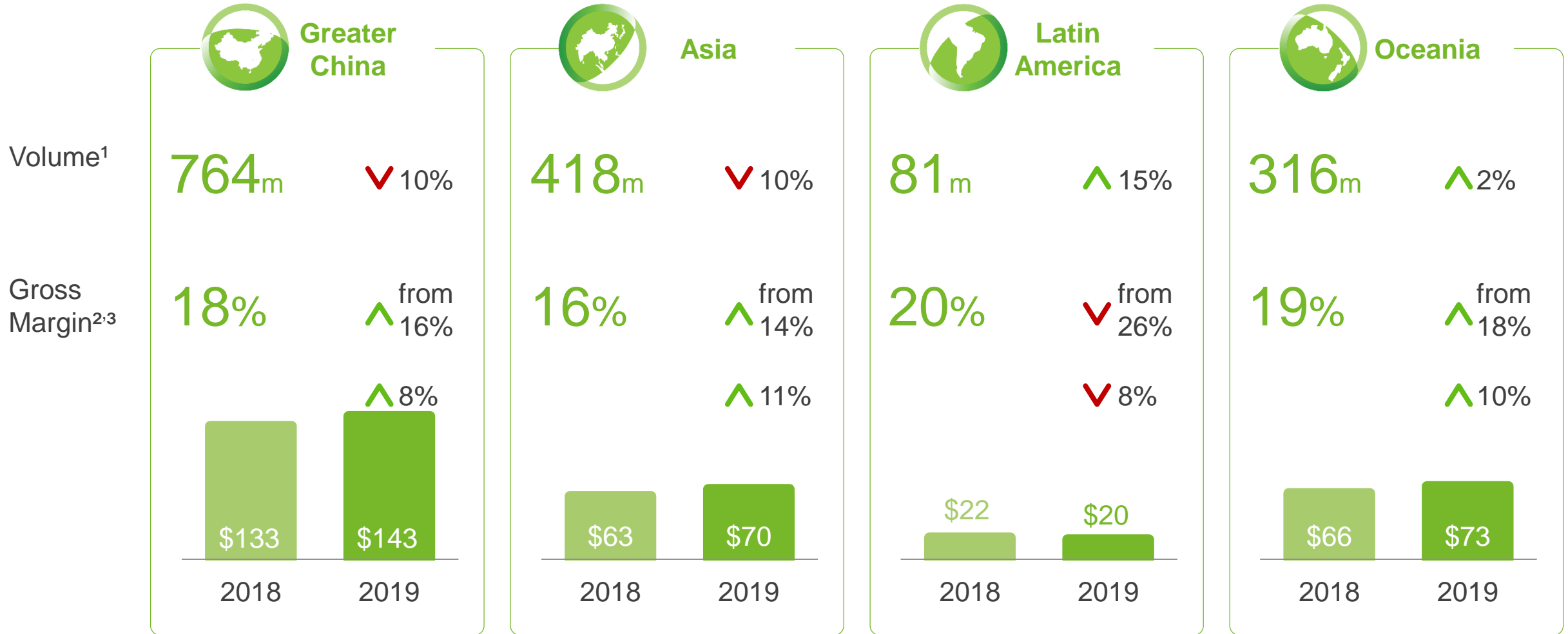
- Improved Q3 sales volume in Greater China and Asia relative to H1, in part due to butter market stabilising
- Greater China gross margin now higher than last year due to
  - reduced input costs
  - improved sales performance in key categories
- Input costs in key Asian markets have stabilised in Q3 allowing for improved margins
- Oceania volume and gross margin remain steady

1. Includes sales to other strategic platforms.

Note: Volume is in million LME. Gross margin is in NZD millions unless otherwise stated. All changes are expressed relative to the nine-month performance of FY18.

# Foodservice

Year-to-date volume lower in Greater China and Asia more than offset by improved gross margin



1. Includes sales to other strategic platforms.

2. Sum of individual numbers from the regional and divisional breakdown may not add to the totals in each category due to rounding.

3. Percentages as shown in tables may not align to the calculation of percentages based on numbers in the tables due to rounding of reported figures.

Note: Volume is in million LME. Gross margin is in NZD millions unless otherwise stated. All changes are expressed relative to the nine-month performance of FY18.

# Glossary

## Acronyms and Definitions

### **AMF**

Anhydrous Milk Fat

### **BMP**

Butter Milk Powder

### **Base Price**

Prices used by Fonterra's sales team as referenced against GDT prices and other relevant benchmarks

### **DIRA**

Dairy Industry Restructuring Act 2001 (New Zealand)

### **GDT**

Global Dairy Trade, the online provider of the twice monthly global auctions of dairy ingredients

### **Gearing Ratio**

Economic net interest-bearing debt divided by economic net interest-bearing debt plus equity excluding cash-flow hedge reserves

### **Farmgate Milk Price**

The price for milk supplied in New Zealand to Fonterra by farmer shareholders

### **Fluid and Fresh Dairy**

The Fonterra grouping of skim milk, whole milk and cream – pasteurised or UHT processed, concentrated milk products and yoghurt

### **kgMS**

Kilogram of milk solids, the measure of the amount of fat and protein in the milk supplied to Fonterra

### **LME (Liquid Milk Equivalent)**

A standard measure of the amount of milk (in litres) allocated to each product based on the amount of fat and protein in the product relative to the amount of fat and protein in standardised raw milk

### **Non-Reference Products**

All dairy products, except for Reference, produced by the NZ Ingredients business

### **Price Achievement**

Revenue achieved over the base price less incremental supply chain costs above those set out in the Milk Price model

### **Reference Products**

The dairy products used in the calculation of the Farmgate Milk Price, which are currently WMP, SMP, BMP, butter and AMF

### **Regulated Return**

The earnings component of Milk Price generated from a WACC return on an assumed asset base

### **Season**

*New Zealand:* A period of 12 months to 31 May in each year

*Australia:* A period of 12 months to 30 June in each year

### **SMP**

Skim Milk Powder

### **Stream Returns**

The gross margin differential between Non-Reference Product streams and the WMP stream (based on base prices)

### **WACC**

Weighted Average Cost of Capital

### **WMP**

Whole Milk Powder

# Glossary

## **Fonterra Strategic Platforms**

### **Ingredients**

The Ingredients platform comprises bulk and specialty dairy products such as milk powders, dairy fats, cheese and proteins manufactured in New Zealand, Australia, Europe and Latin America, or sourced through our global network, and sold to food producers and distributors in over 140 countries. It also includes Fonterra Farm Source™ retail stores.

### **Consumer**

The Consumer platform comprises branded consumer products, such as powders, yoghurts, milk, butter, and cheese. Base products are sourced from the ingredients business and manufactured into higher-value consumer dairy products.

### **Foodservice**

The Foodservice platform comprises a range of branded products and solutions for commercial kitchens, including bakery butter, culinary creams, and cheeses.

### **China Farms**

The China Farms platform comprises the farming operations in China, which produce high-quality fresh milk for the Chinese market.