

WESTPAC DAIRY UPDATE

GlobalDairyTrade auction results and forecast update.

7 June 2023

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Mr Cheese.

- Global dairy consumers have fallen in love with cheese, with cheese prices sizzling at or near record highs since late 2021.
- Unfortunately, New Zealand is not well-placed (relatively) to take advantage of this trend and total dairy farmer incomes will be lower than they would ordinarily be.
- As a result, we lower our 2023/24 milk price forecast to \$8.90/kg.
- At the same time, we expect significantly larger Fonterra dividends on the back of higher profits in its cheese (and protein) businesses, albeit these dividends won't fully offset our lower milk price forecast.

Farmgate milk price forecasts

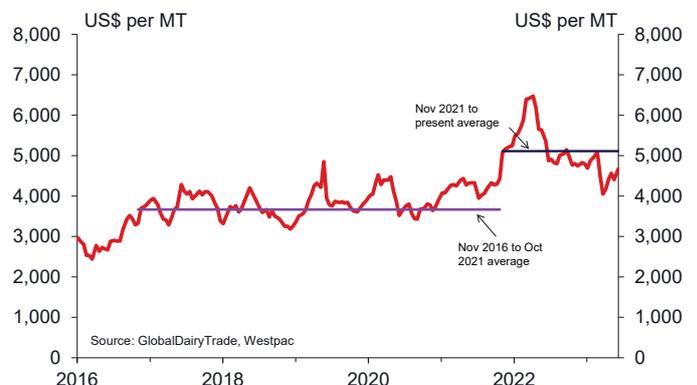
	2022/23		2023/24	
	Westpac	Fonterra	Westpac	Fonterra
Milk price	\$8.20	\$8.10-\$8.30	\$8.90	\$7.25-\$8.75

Cheesy trend.

Growing up, my daughter loved cheese. So much so that when it came to pizza night, her Dominos order was always the same – 'Mr Cheese'. What pizza would you like tonight sweetie? Mr Cheese! And what pizza would you like tonight? Don't tell me, Mr Cheese!

Now, I'm not saying that my daughter started a global trend, but the world now definitely loves cheese. Indeed, reflecting this global love affair, since late 2021, global cheese prices have averaged 32% higher than the five-year average prior i.e., between November 2016 and October 2021.

Global cheese prices



Pinning down the exact genesis for the cheesy trend is a question for the marketing experts – however, we suspect it has something to do with Covid lockdowns, the ease of pizza

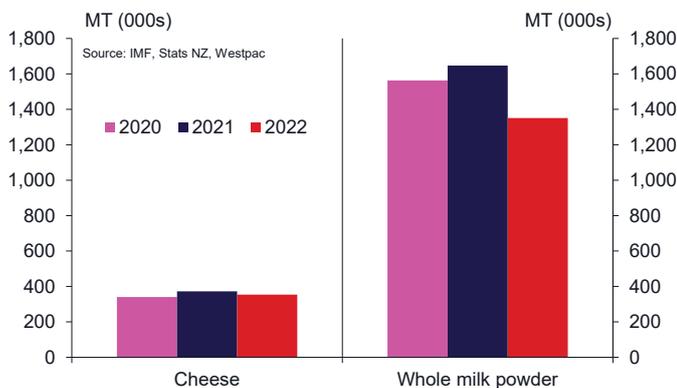
deliveries during said lockdowns, and therefore a new-found love of cheese in the large fast-growing markets in Asia.

New Zealand not relatively well-placed...

While increasing global consumption of dairy products is normally a good thing for New Zealand, we are not well-placed to benefit from higher cheese prices, at least in the short term. New Zealand dairy companies have limited (factory) capacity to produce more cheese. And while cheese production has expanded where possible, in the short term, these companies are stuck producing other less profitable products like whole milk powder (WMP).

The chart below shows that despite sizzling cheese prices, New Zealand has been unable to materially increase cheese export volumes. Note we have been able to divert some WMP production to other products (like butter), but ideally we would be switching more WMP production into cheese.

New Zealand dairy export volumes

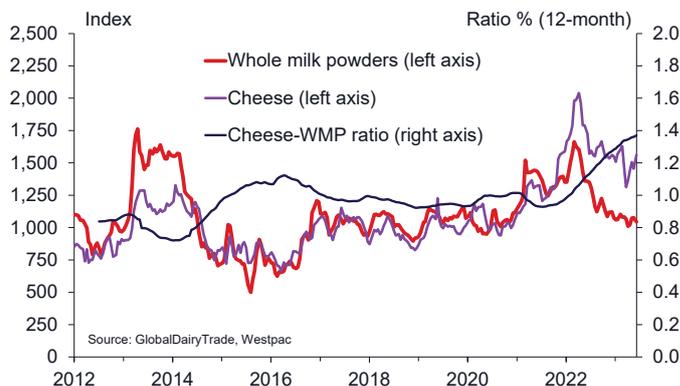


Note some commentators have pointed to rising Chinese WMP production as a sign of increasing Chinese self-sufficiency and/or notable strength in Chinese dairy production. In our view, China is filling the gap left by global dairy exporters. Indeed, if we could, we would be producing even more cheese and subsequently even less WMP, creating an even larger WMP gap for China to fill.

... and this will translate into a lower milk price than otherwise.

With cheese production capacity capped, New Zealand dairy export incomes are not optimal given the current mix of global dairy product prices. Translation: the total of the milk price plus the Fonterra dividend will not equal what the farmgate milk price would be given a normal mix of prices. As the chart below shows, cheese prices have never been this high relative to WMP before.

Cheese and whole milk powder prices



Indeed, the global dairy market is generally healthy. Global demand is not soft. On the contrary, there is large amount of unmet cheese demand (and a relative oversupply of WMP). We also note that global production is generally soft. We expect flat production growth in the US or EU over calendar 2023 and for New Zealand production to grow at about 1% this year. Meanwhile, in Australia and Argentina, production continues to fall.

With the above in mind, we maintain our positive dairy outlook, but lower our 2023/24 milk price forecast to \$8.90/kg. This puts our forecast slightly above the top end of Fonterra’s forecast range of \$7.25/kg to \$8.75/kg.

Higher Fonterra dividends will provide some partial offset.

At the same time, we expect high Fonterra dividends for farmers over the season just gone and also for 2023/24. This is a new development given the low dividends Fonterra has paid over recent years and to a degree changes the dynamic around returns to farmers.

Last month, Fonterra said that it expects normalised earnings per share of 65-80 cents for 2022/23. Assuming it pays 70% of its earnings as a dividend, this equates to a dividend of between 45.5 and 56 cents per share.

We anticipate that Fonterra will continue to pay a similar dividend over 2023/24. Adding this together to our forecast milk price equates to between \$9.355/kg to \$9.46/kg. In other words, the healthy dividend does not fully offset our lower milk price forecast (as Fonterra cannot fully capitalise on very high cheese prices).

Other food for thought.

A key question going forward is how long will cheese prices stay high? And secondly, how soon can Fonterra and other dairy companies start to produce more cheese?

For now, we assume that the cheese price strength and relative WMP weakness persists over the year (on top of an underlying

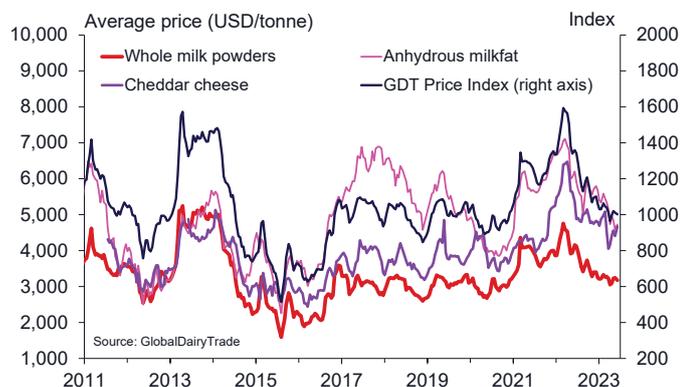
increase in global dairy prices). Essentially, it's relatively difficult to build new capacity over this sort of short-term horizon. However, if New Zealand companies can produce significantly more cheese in the next 12 months, then cheese prices will fall and WMP prices will rise. In this case, the milk price will be higher and Fonterra dividends lower i.e. closer to our previous forecast.

Auction Results, 7 June.

GlobalDairyTrade auction results

	Change since last auction	Prices USD/tonne
Whole Milk Powder (WMP)	-3.0%	\$3,173
Skim Milk Powder (SMP)	0.0%	\$2,755
Anhydrous Milk Fat (AMF)	1.8%	\$4,728
Butter	0.5%	\$5,088
Cheddar	7.4%	\$4,668
GDT Price Index	-0.9%	1002

Global dairy prices



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