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New Zealand Dairy Companies Review

TDB
ADVISORY

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- directors of other dairy farming businesses that are Fonterra Co-operative Group Limited suppliers and shareholders, Synlait Milk Limited suppliers, MyMilk suppliers; Westland Dairy Company Limited suppliers, and Miraka Limited suppliers; and
- investors in and former directors of Open Country Dairy Limited.

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Glossary

Capital Employed	Taken as the average of net debt plus equity of the current and previous year.
EBITDA	Earnings before interest, tax, depreciation and amortization is a measure of a company's operating performance.
FGMP	The farmgate milk price is the average price paid per kilogram of milk solids by Fonterra to its shareholder suppliers.
Global Dairy Trade™	The GDT provides an online globally connected dairy trading platform that provides market-based reference prices for dairy commodities.
Milk solids (kgMS)	Milk solids refers to the amount of protein and fat in a quantity of milk. Production of 1 kg of milk solids requires approximately 12 litres of milk.
Normalised earnings	Normalised earnings represent a company's earnings after excluding non-recurring charges or gains to better represent a company's core business.
ROCE	Return on capital employed is a financial performance measure that compares the relative profitability of companies by factoring in the average amount of capital employed.
Value-Added	Value-added refers to the enhancement of a raw material or commodity.
Weighted Average Cost of Capital	The weighted average cost of capital (WACC) is the average cost of a firm's capital in which each category of capital (debt and equity) is proportionately weighted.

Overview

This report reviews the financial results of the seven New Zealand dairy processing companies that publish their financial statements. The focus is on the financial results for the fiscal year 2019 as that is the last year for which data for all companies is available.

Fonterra

FY2019 was a difficult year for Fonterra in an absolute sense to the extent that it incurred significant one-off type costs associated with implementing a comprehensive strategic review of its business. Fonterra has recently announced its fiscal year 2020 financial results, which show a significantly improved performance.

Mataura

FY2019 was Mataura's first full operational year. It appears to have been a difficult year for the company with it not being able to generate sufficient revenue per kgMS sold while incurring the high operating costs associated with producing value-add products. The a2 Milk Company recently announced that it has made a non-binding bid to acquire 75.1% of Mataura with the existing majority shareholder owning the balance.

Oceania

Oceania's financial performance is improving year-on-year; however, its cost of goods sold and operating expenses are too high relative to the amount of revenue it is able to generate per kgMS. The company's revenue per kgMS is similar to Synlait but its cost of goods sold and operating expenses are significantly higher.

Open Country

FY2019 was a good year for Open Country. It was able to generate higher revenue per kgMS sold in an environment of decreasing commodity prices. While its return on capital employed was modest vis-à-vis Synlait and Tatua, it was higher than our approximate assessment of the company's weighted average cost of capital.

Synlait

FY2019 was a good year for Synlait. Its return on capital employed was less than what it was the previous year but higher than its six year average and higher than our approximate assessment of its weighted average cost of capital. Synlait has recently released its fiscal year 2020 financial results. Its return on capital employed was lower than 2019 as a consequence of significant capital expenditure on as yet under-utilised assets.

Tatua

FY2019 was an excellent year for Tatua. Its return on capital employed was more than twice what it was in the previous year and significantly higher than its 6-year average. In our assessment, Tatua has the riskiest strategy of all the milk processing companies but on average its return on capital employed has exceeded our estimate of the company's weighted average cost of capital.

Westland

FY2019 was a difficult year for Westland with Westland's shareholders deciding to sell the company to Oceania's parent. Westland's financial performance was worse than it would otherwise have been owing to the one-off costs associated with its restructure.

Inter-company

The inter-company comparison indicates that Tatua is the stand-out performer. It very successfully operates at the value-add end of the product spectrum generating strong returns for its shareholders. After Tatua, Synlait was the most profitable on an EBITDA per kgMS basis, followed by Oceania, Open Country, and Fonterra (in descending order). Fonterra's performance was negatively affected by one-off type costs. We would expect Fonterra to sit third in those rankings in a normal year for it.

As expected, Open Country had the lowest operating expenses. Like revenue per kgMS, operating expenses per kgMS reflect the companies' product strategies. Open Country chooses to operate more towards the commodity-end of the spectrum than the other companies and therefore has relatively very low operating expenses – approximately one 15th of Tatua's on a per kgMS basis.

Oceania had the strongest balance sheet on the basis that it has no debt at all. Mataura had the weakest balance but was able to borrow debt that was secured by its parent.

Introduction

Purpose

The purpose of this report is to objectively measure the financial performances of the New Zealand dairy processing companies that publicly report their financial statements. The seven companies covered in this review are Fonterra, Mataura, Oceania, Open Country, Synlait, Tatua and Westland.

The year under review is fiscal year 2019. The first section of the report compares the financial performances of the various processing companies in FY2019. In the following sections, we review the historic financial performance of each of the companies.

Both Fonterra and Synlait have recently released their financial results for FY2020. We comment briefly on those results at the end of the two companies' respective sections.

Background

The two distinguishing characteristics of the New Zealand dairy industry are the seasonality of its production and the level of total production relative to domestic demand. New Zealand farmers employ a pasture-based farming system that means that milk production follows the grass curve – more milk is produced when more grass is growing and less milk when less grass is growing. In terms of total production, only 5% of the milk produced in New Zealand is consumed domestically with 95% being processed into export products.

Both characteristics mean that the fresh milk that is produced has to be converted into a form that can be stored and efficiently transported – that form being predominantly milk powders such as whole milk powder (WMP) and skim milk powder (SMP).

On a global basis, New Zealand is not a particularly large milk producer but because only a very small proportion of global production is internationally traded, New Zealand's share of the international market is relatively very large – approximately 30%. New Zealand is the largest participant in the international market.

With so much production exported, the milk price paid to New Zealand farmers is a function of international commodity prices.

Strategy and Structure

In terms of strategy, Open Country operates more towards the commodity end of the product spectrum while Tatua operates more at the value-add end. In between those two companies lies Synlait, which has historically had a business-to-business strategy but has relatively recently ventured into the domestic consumer market, and Fonterra, which until relatively recently has not only had an ingredients and consumer and food service strategy but also a global milk pool strategy. The milk processing industry also includes two dairy companies, Oceania and Mataura, that have been established predominantly to supply their foreign owners with New Zealand milk.

In terms of company structure, the firms vary from co-operative companies (of which there are now only two, Fonterra and Tatua - with Westland having been sold to Oceania in August 2019) to privately owned companies, unlisted code companies, listed companies and subsidiaries of foreign companies.

The 2018/19 and 2019/20 seasons in review

The 2018/19 regulated farm gate milk price (FGMP) was $6.35/kgMS. We estimate that the weighted average USD price of the reference commodity products sold on Global Dairy Trade™ (GDT) in 2018/19 was US$3,015, approximately 8.0% below the 10-year average of US$3,275. The price variation during the season was approximately one third of the 10-year variation. The average USD:NZD exchange rate during the season was US$0.6740 compared to the 10-year average of US$0.7455.

We estimate that the weighted average NZD price of the reference commodity products sold on Global Dairy Trade™ in 2018/19 was NZ$4,350, only marginally less than the 10-year average of approximately NZ$4,360. Figure 1 below shows the NZD value of the reference commodity products sold on Global Dairy Trade™ over the last two seasons versus the 10-year average price.

The 2019/20 FGMP was $7.14. We estimate that the weighted average USD price of the reference commodity products sold on Global Dairy Trade™ in 2019/20 was US$3,170, approximately 3.0% below the 10-year average of US$3,255. The price variation during the season was approximately one quarter of the 10-year variation. The average USD:NZD exchange rate during the season was US$0.6405 compared to the 10-year average of US$0.7395.

We estimate that the weighted average NZD price of the reference commodity products sold on Global Dairy Trade™ in 2019/20 was NZ$4,840, approximately 10% more than the 10-year average of approximately NZ$4,395.

Figure 1: Reference Commodity Product prices, May 18-Sep 20, NZ $

Foreign exchange

New Zealand farmers have benefitted in recent years from a relatively weak NZD with USD dairy prices hovering around the 10-year average while NZD prices have been above average. Our best guess is that that weakness contributed an additional 15 cents to the 2018/19 FGMP and an additional 95 cents to the 2019/20 FGMP.

FGMP-equivalent history

FGMP-equivalent price frequency, 2008-2020, NZ $

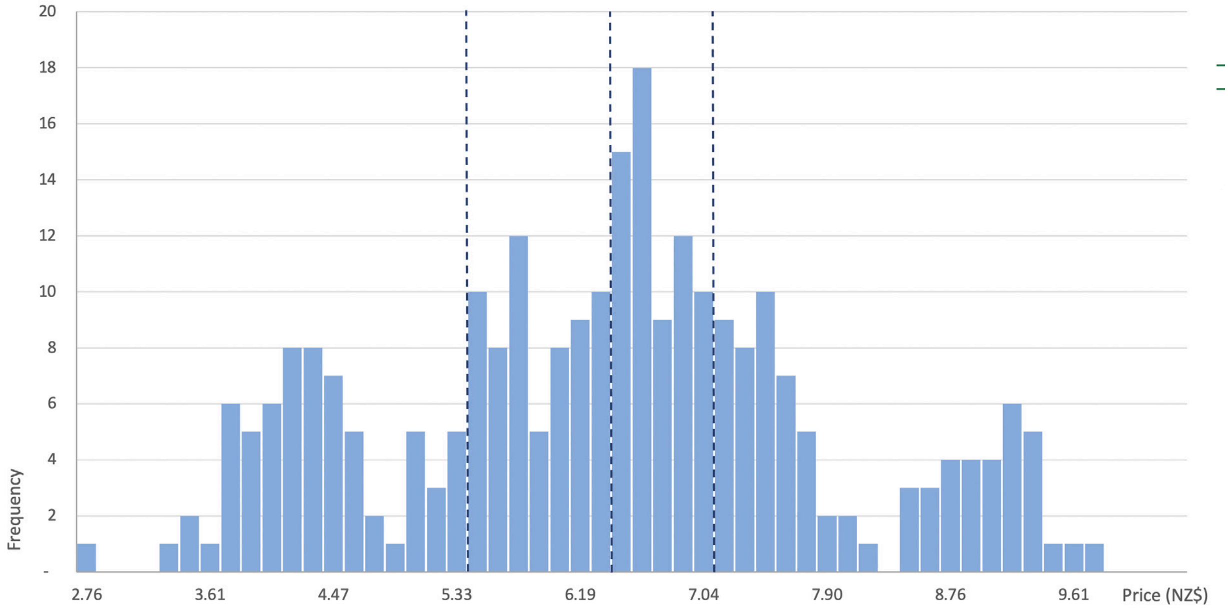


Figure 2 above shows all the FGMP-equivalent prices achieved at each Global Dairy Trade™ auction since 2008. These FGMP-equivalent prices are approximations only. The graph indicates that 25% of prices are less than the FGMP-equivalent of $5.35, 50% are less than $6.40, and 75% are less than $7.20. Beyond the 25% and 75% bounds, most of the higher prices came in the period between March 2013 and April 2014 and most of the lower prices came in the period between September 2014 and September 2016.

Risk

The most significant risk in the dairy industry is commodity price risk. The traditional co-operative structure passed all commodity risk back to farmers via the pay-out leaving the processors with just a margin. The further along the value-add spectrum dairy companies move, the more of the commodity price risk they assume for themselves. A value-add strategy is also a much more capital intense strategy, which amplifies the risk. With that context, we see Open Country as being the lowest risk processor in New Zealand and Tatua being the highest. That being the case, the return on capital requirements of Open Country's shareholders will be the lowest and Tatua's will be the highest. Fonterra sits somewhere between those two, more towards Open Country than Tatua. Fonterra's required return on its capital employed (weighted average cost of capital (WACC)) in its commodity business in FY2019 was 5.2%.

Essential industry statistics

Processing companies

There are eight farmer-supplied processing companies in New Zealand. They are:

1. Fonterra Co-operative Group Limited (Fonterra)
2. Mataura Valley Milk Limited (Mataura)
3. Miraka Limited (Miraka)
4. Oceania Dairy Limited (Oceania)
5. Open Country Dairy Limited (Open Country)
6. Synlait Milk Limited (Synlait)
7. The Tatua Co-operative Dairy Company Limited (Tatua)
8. Westland Co-operative Dairy Company Limited (Westland)

Mataura is the most recent industry entrant with the 2018/19 being its first full processing year. On 1 August 2019, Westland's shareholders sold their company to Oceania. Westland's name has subsequently been changed to Westland Dairy Company Limited and its balance date has been changed to 31 December, in line with that of its parent. In this report we review the financial performance of all of the above companies except Miraka. Miraka's financial performance is not required to be and is not publicly disclosed.

Production

New Zealand's total milk production over the last six years has remained relatively static as follows:

Season	(000s kgMS)
2014/15	1,889,885
2015/16	1,862,752
2016/17	1,851,006
2017/18	1,839,175
2018/19	1,883,558
2019/20	1,895,963

The largest annual variation in production was from the 2017/18 season to the 2018/19 season when annual production increased by 2.4%.

Annual production in the 2018/19 season was 0.3% less than what it was in the 2014/15 season.

Farm gate milk price (FGMP)

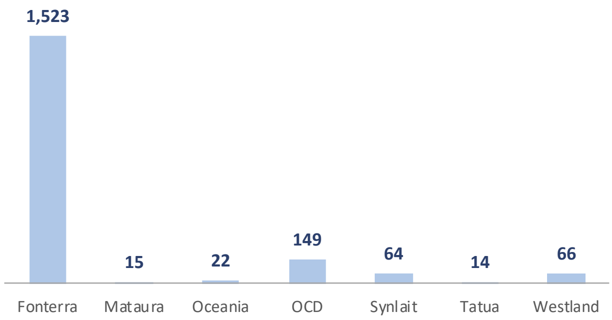
There has been a large variation in the FGMP over the last six years as follows:

Season	(000s kgMS)
2014/15	$4.40
2015/16	$3.90
2016/17	$6.12
2017/18	$6.69
2018/19	$6.35
2019/20	$7.14

The average annual absolute change in the FGMP has been almost 24%.

Inter-company comparisons

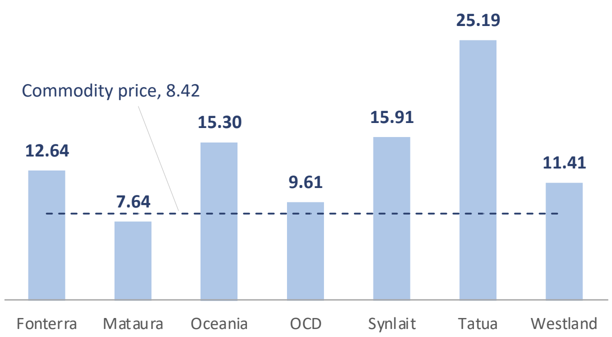
Volume, 2019, kgMS millions



The above graph illustrates the size of Fonterra relative to the rest of the industry. Fonterra is four times larger than all the other participants combined in terms of kgMS processed.

Open Country is approximately twice the size of the next largest milk processors, Synlait and Westland. We calculate that Open Country and Synlait are the only two processors that added volume of any significance during FY2019.

Revenue per kgMS, 2019, $



Sales of the reference commodity products on a weighted average basis generated revenue of $8.42 per kgMS (FOB) during FY2019. The graph above illustrates the approximate amount of revenue each milk processing company added to its milk in that year.

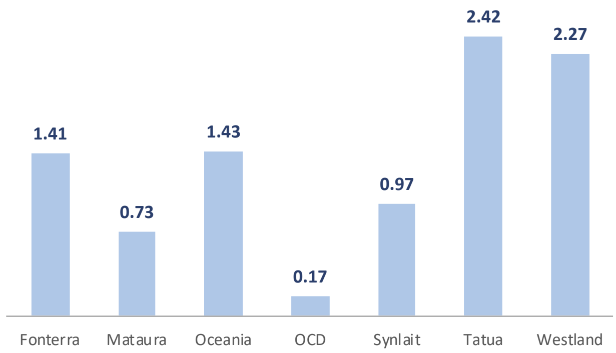
The graph above suggests that Mataura was either under-selling the market or that it didn't have a full suite of reference commodity products available for sale and that those products that it did have were relatively under-valued by the market in FY2019.

For example, we know that the average price of protein was approximately 20% below its long-term average in FY2019 and that fat was approximately 25% above its long-term average so it may have been that Mataura wasn't able to fully exploit fat prices. A third possible but less probable explanation is that it is a timing difference with Mataura's financial year ending on 31 December versus Fonterra's financial year end being 31 July.

In contrast, Tatua generated revenue per kgMS sold close to three times the commodity value.

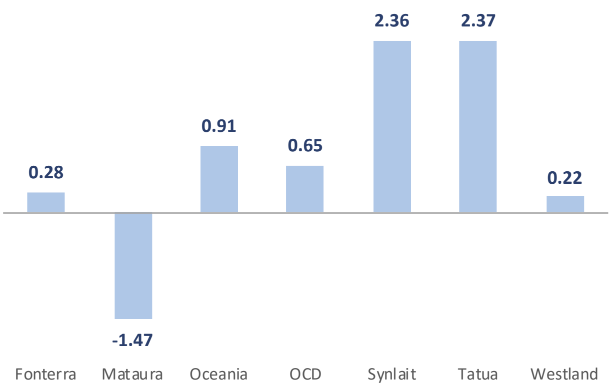
As a point of reference, approximately 30% of Fonterra's sales were value-add (ie. consumer and food service) sales. Given that a value-add strategy and capital intensity go hand-in-hand, when we look at the amount of capital employed per kgMS, we would expect to see Open Country at the low end and Tatua up the high end (refer Section 4.5 below).

Operating expenditure per kgMS, 2019, $



Like revenue per kgMS, operating expenses per kgMS vary depending on the support required to market dairy products – very little for products that are more commodity-like with increasing amounts as the proportion of total production that is value-add increases. The two extremes are Open Country at one end of the spectrum and Tatua at the other. Westland looks like the odd one out. Its operating expenses per kgMS are high but approximately $0.40 of Westland's number is the consequence of the restructuring it completed just after the end of FY2019.

EBITDA per kgMS, 2019, $

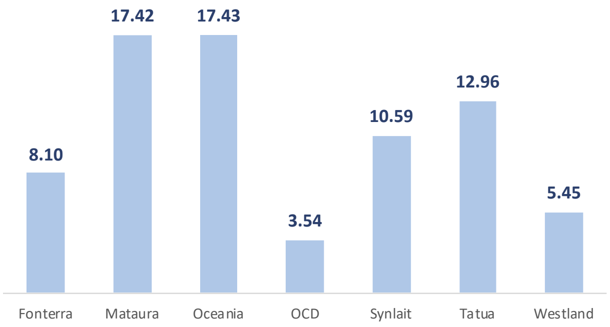


Fonterra's EBITDA was negatively impacted by the losses incurred by discontinued operations.

Mataura clearly had a tough first full year of operations. A combination of low sales revenue plus a high milk cost and high operating expenses meant that it had a negative EBITDA. Tatua's EBITDA is understated to the extent that it paid its farmers $2.15 more than the FGMP. If we normalise Tatua's EBITDA by adjusting the amount it paid for milk to the FGMP, its EBITDA per kgMS would be $4.52.

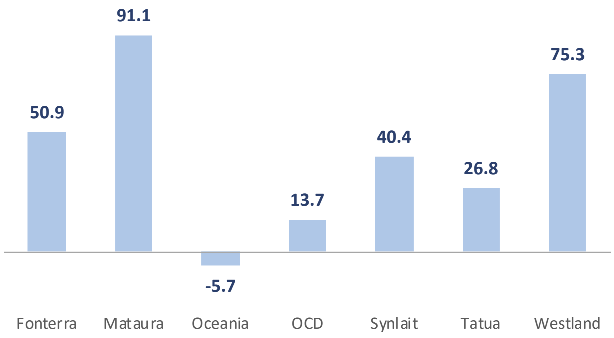
Synlait's performance was also impressive. Westland's EBITDA performance was affected by one-off restructuring costs.

Capital employed per kgMS, 2019, $



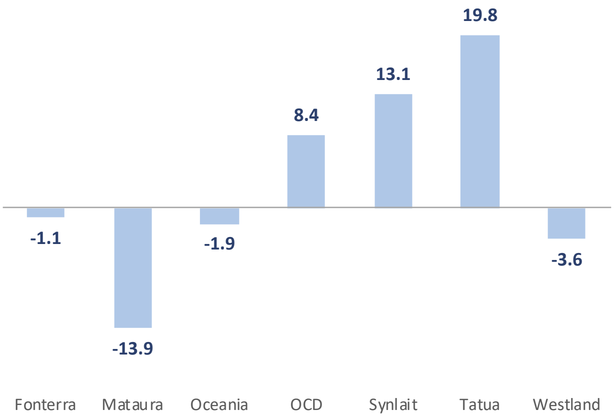
Mataura and Oceania have the most capital employed per kgMS but the figures are probably overstated to the extent that both have relatively new plants and some of the other companies have relatively old plants that have depreciated significantly over time. Otherwise the graph shows us what we would expect – more capital employed to produce the more expensive value-add products versus less capital employed to produce more commodity-like products.

Leverage (net debt / net debt + equity), 2019, %



Fonterra's targeted leverage is 40-45%. Mataura used a lot of debt to fund the construction of its plant and has subsequently required more debt to fund its operating losses. Oceania has no debt and has cash in the bank. Westland's leverage increased during the year to fund asset purchases and operating losses.

Return on capital employed, 2019, %



All of the various measures above converge into the ROCE measure. Tatua's earnings have been normalised by adjusting its milk payout to the FGMP.

Fonterra, Mataura, Oceania, and Westland had negative earnings and hence a negative ROCE.

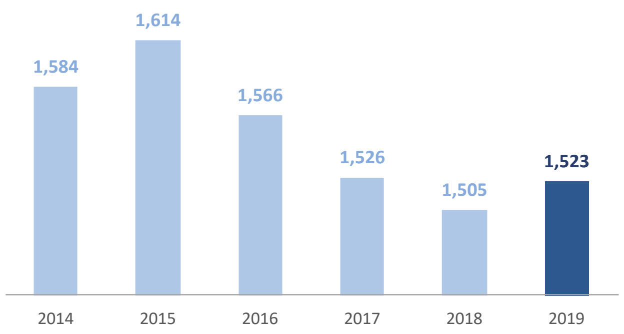
We estimate Open Country's financial risk to be less than Synlait's risk and for Synlait's risk to be less than Tatua's risk on the basis of the amount of commodity price risk each of those businesses is exposed to and the capital intensity of a value-add strategy. Allowing for risk, the ROCE of each of these companies is impressive.

Fonterra

Fonterra is a global business. It exports to more than 140 countries 95% of the 16 billion litres of milk it collects and processes annually. It has 10,000 shareholder suppliers and more than 30 manufacturing sites across New Zealand.

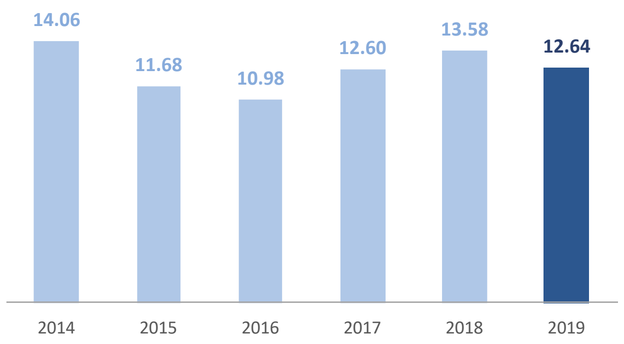
The numbers used in this section are not what Fonterra describes as "normalised" numbers. The numbers in this section are the actual numbers reported. "Normalised" numbers exclude the one-off type costs incurred in any given year for the likes of impaired assets or costs associated with a major strategic review.

Volume, 2014-2019, kgMS millions



While total New Zealand milk collections increased by 2.4% in 2019, Fonterra's milk collected increased by 1.2% - the implication being that Fonterra's share of total supply decreased from 81.8% to 80.9%.

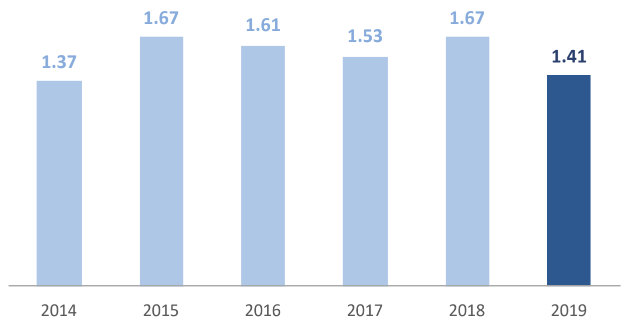
Revenue per kgMS, 2014-2019, $



Approximately 30% of Fonterra's total volumes go into its Consumer & Foodservice business with the remainder being sold as Ingredients. Consumer & Foodservice revenue per kgMS is approximately 70% higher than Ingredients revenue per kgMS.

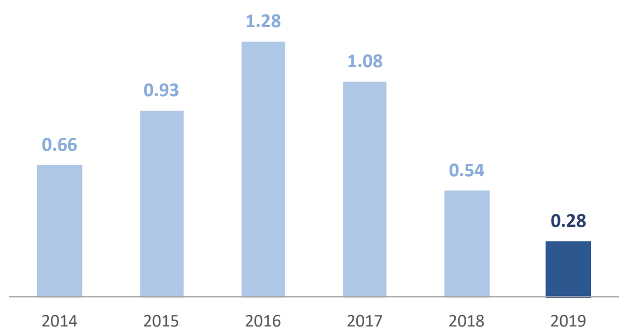
Fonterra's average revenue per kgMS decreased by $0.94. Some of that decrease can be explained by the fall in commodity prices ($0.33) but the remainder ($0.61) suggests either a change in product mix or that Fonterra's gross margins were squeezed.

Operating expenditure per kgMS, 2014-2019, $



Fonterra focused on taking costs out of its business in FY2019. It appears to have done this successfully with operating expenditure per kgMS at the lowest it has been for five years.

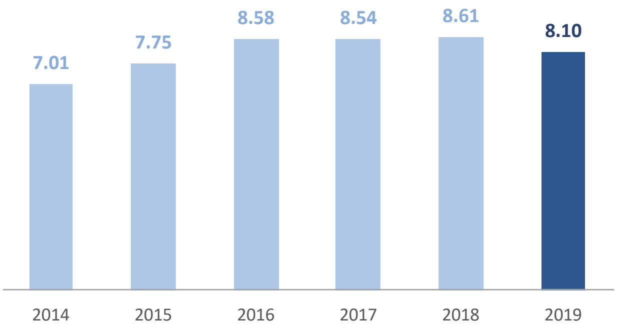
EBITDA per kgMS, 2014-2019, $



Fonterra under-performed in FY2018 and FY2019 mostly as a consequence of the costs associated with the processes it instigated to clean up its balance sheet (such as revaluing assets) and focus on its core business. On a normalised basis, EBITDA per kgMS in FY19 was comparable with other years due to the company's operating expenditure management partly offsetting a squeeze on gross margins.

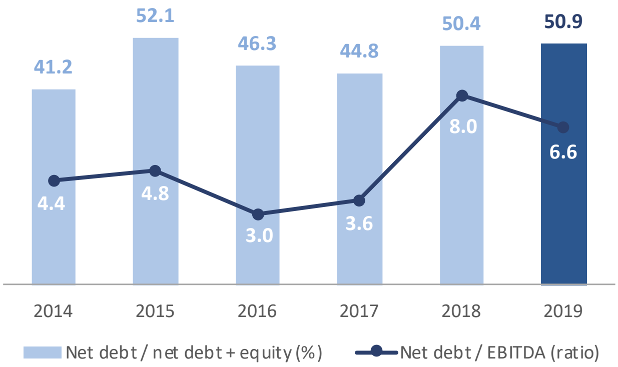
The FY18 EBITDA shown above includes the impairment of assets such as Beingmate. If excluded, EBITDA would increase by $0.40 per kgMS. The FY19 EBITDA shown above includes the cost of implementing Fonterra's strategic review and losses incurred by discontinued operations. If excluded, EBITDA would increase by $0.64 per kgMS.

Capital employed per kgMS, 2014-2019, $



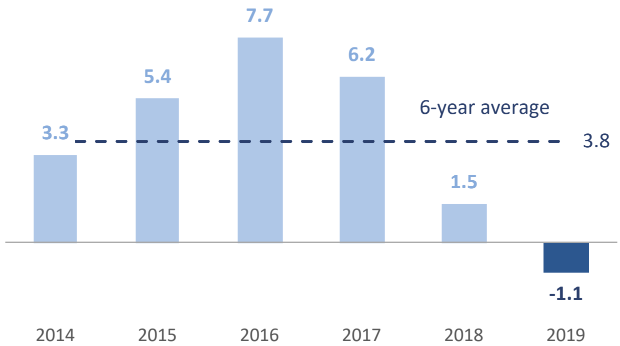
Total capital employed decreased as a result of Fonterra recording a net loss for the year and reducing debt by over $400 million.

Leverage (net debt / net debt + equity), 2014-2019



The balance sheet leverage measure (net debt / net debt + equity) has remained largely static because equity decreased proportionally by as much as net debt. The earnings leverage measure (net debt / EBITDA) improved in 2019 as a result of both lower net debt and higher earnings. While the earnings measure is still high, it will improve in future seasons as Fonterra's earnings continue to improve and as debt is repaid following asset sales.

Return on capital employed, 2014-2019, %



Fonterra's average ROCE over the last six years of 3.8% has been below its average weighted average cost of capital of somewhere between 6% and 7%. As expected, ROCE was low in FY2014 when the FGMP was very high ($8.40) and the ROCE was high in the following two seasons when the FGMP was very low ($4.40 and $3.90 respectively). Fonterra performed well in FY2017 when the FGMP was $6.12. Not surprisingly, Fonterra's ROCE has been poor in the last two seasons owing to one-off costs associated with cleaning up its balance sheet and implementing its strategic review.

FY2020

Fonterra collected 1,517 million kgMS in FY2020 and its share of total milk collections decreased from 80.9% to 80%.

Fonterra's EBITDA / kgMS was $1.16, almost as good as it was in 2016 – that being in spite of the FGMP being high at $7.14.

Mataura

The Mataura plant was set up to produce nutritional powders for children in the 0-36 month age group as well as commodity powders. The 2018/19 season was Mataura's first full operational year.

Direct comparison with Fonterra is difficult as Mataura's financial year end is 31 December whereas Fonterra's is 31 July.

The a2 Milk Company has recently announced that it has made a non-binding bid to acquire 75.1% of Mataura with the existing majority shareholder continuing to own the balance.

Volume, 2014-2019, kgMS millions

The 2018/19 season was Mataura's first full season. The volume shown above is our best estimate of volumes of milk processed by Mataura. This estimated volume represents less than 1% of New Zealand's total production.

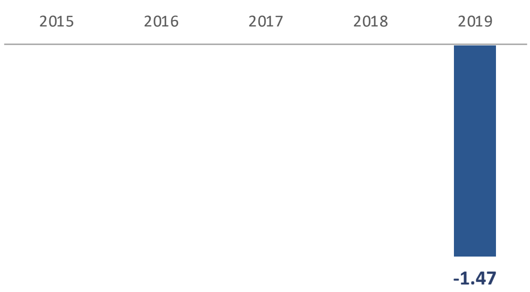
Operating expenditure per kgMS, 2014-2019, $

Operating expenditure of $0.73 per kgMS is competitive relative to other processors who are targeting value-add products, but is too high for a company generating revenue less than the commodity price.

Revenue per kgMS, 2014-2019, $

As noted above, Mataura is targeting to sell nutritional powders for children in the 0-36 month age group. However, revenue per kgMS of $7.64 was less than the commodity price of $8.42 and less than what is required to pay a competitive milk price and stay profitable.

EBITDA per kgMS, 2014-2019, $

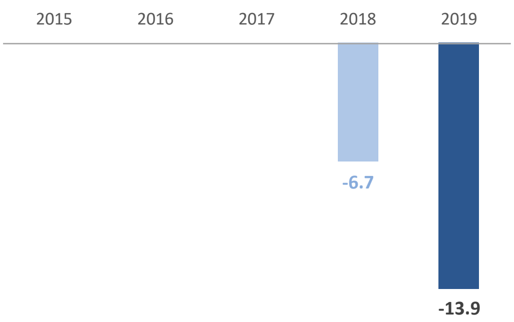


The loss at the EBITDA line is a function of generating insufficient revenue per kgMS sold relative to cost of sales. Mataura's cost of sales was higher than its revenue. Mataura has a milk price policy of paying approximately 20 cents per kgMS more that its local competitors plus additional incentives.

Capital employed per kgMS, 2014-2019, $

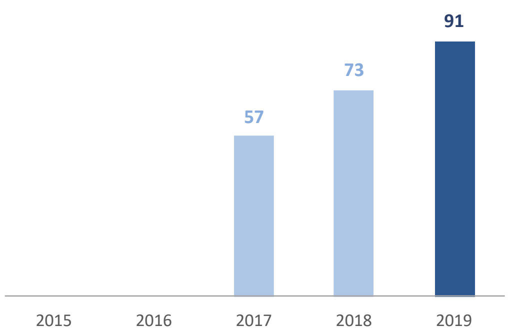
Capital employed per kgMS is a function of the products that Mataura intends to produce and sell. This amount of capital is representative of a plant built to produce nutritional powders.

Return on capital employed, 2014-2019, %



Mataura's negative ROCE is a function of it generating losses in its start-up years.

Leverage (net debt / net debt + equity), 2014-2019, %



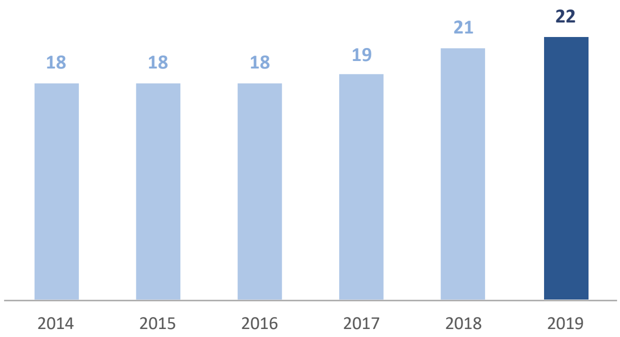
Leverage increased over time as construction proceeded. More debt was required in Mataura's first full year of operation to fund its operating losses.

Oceania

Oceania was originally set up to supply milk products to its parent company either as finished goods ready to go directly to supermarket shelves in China or as base ingredients for further blending and packaging.

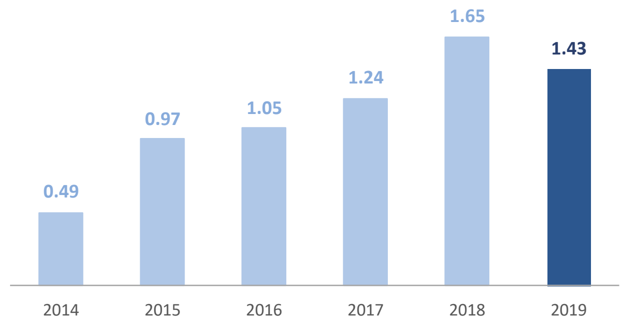
Direct comparison with Fonterra is difficult as Oceania's financial year end is 31 December whereas Fonterra's is 31 July.

Volume, 2014-2019, kgMS millions



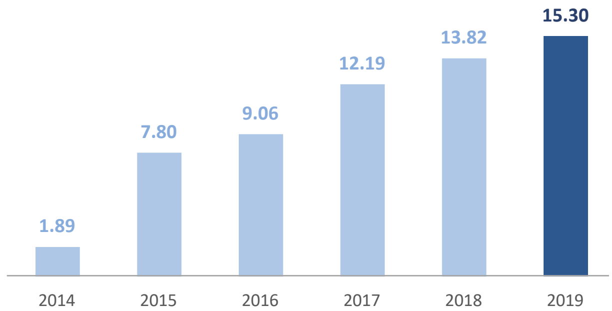
The volumes shown in the graph above are our best estimate. The estimated volume represents just over 1% of New Zealand's total production. During calendar year 2019, Oceania purchased Westland Co-operative Dairy Company. The volume figures depicted above exclude Westland volumes.

Operating expenditure per kgMS, 2014-2019, $



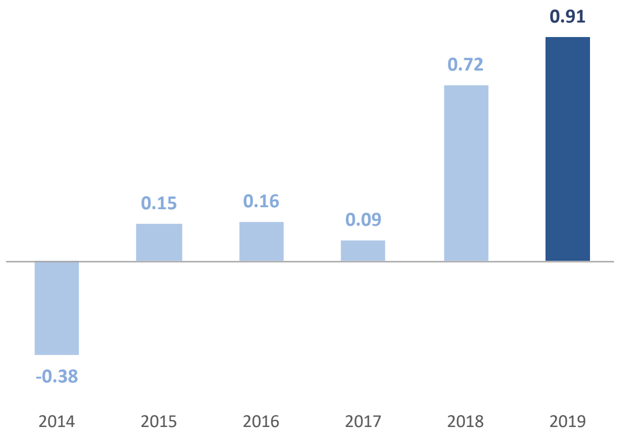
Operating expenses per kgMS are high relative to the amount of revenue the company is generating. Oceania will need to increase its gross margins to accommodate this level of operating expenditure.

Revenue per kgMS, 2014-2019, $



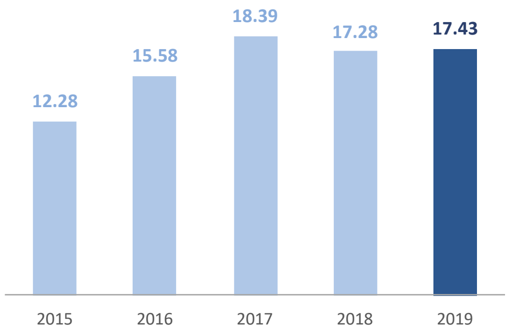
Oceania was originally established to sell either finished or base products to its parent company in China. Its revenue per kgMS has increased year-on-year but not by enough to sufficiently cover its cost of sales or other operating expenses in order to prevent the company from making a small loss each year. Given the level of capital employed, it would be reasonable to expect revenue per kgMS to be higher than it is.

EBITDA per kgMS, 2014-2019, $



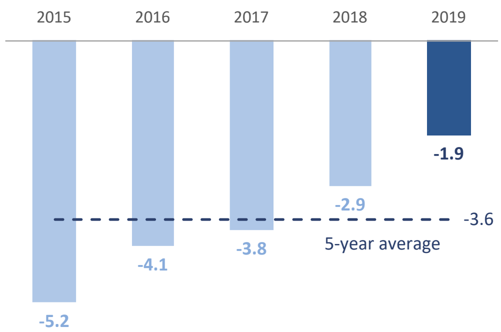
Oceania's EBITDA per kgMS is low given its target market, primarily as a consequence of its cost of sales being too high.

Capital employed per kgMS, 2015-2019, $



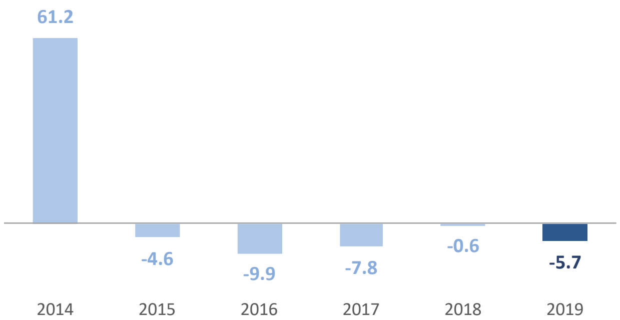
Oceania's capital employed (per kgMS) is similar to Mataura's but high relative to all the other processors in New Zealand.

Return on capital employed, 2015-2019, %



Oceania's earnings have been negative year-on-year.

Leverage (net debt / net debt + equity), 2014-2019, %



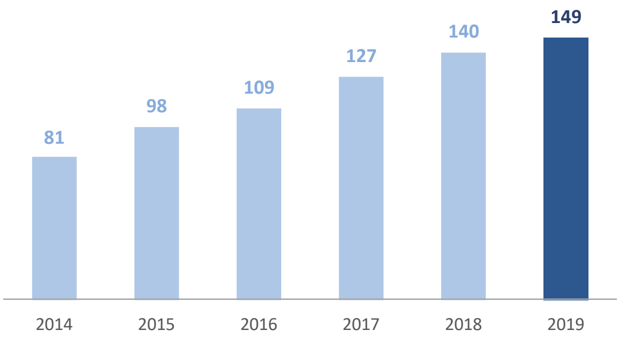
Oceania doesn't have any debt and has cash on hand.

Open Country

Open Country is the second largest global exporter of whole milk powder. Open Country produces milk powders, milk proteins, milk fats and cheeses for export markets.

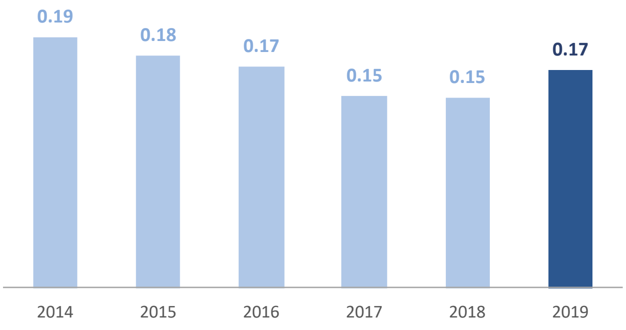
Direct comparison with Fonterra is difficult as Open Country's financial year end is 30 September whereas Fonterra's is 31 July.

Volume, 2014-2019, kgMS millions



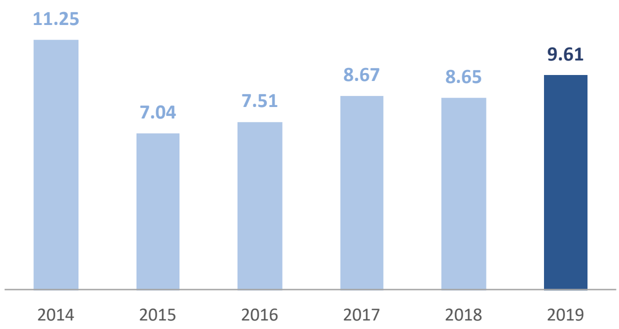
The volumes shown in the graph above are our best estimates. The estimated volume in 2019 represents just under 8% of New Zealand's total production.

Operating expenditure per kgMS, 2014-2019, $



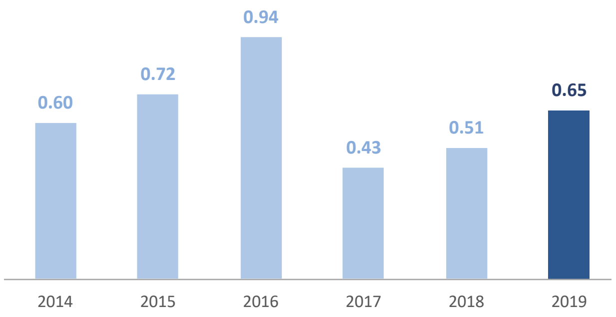
Open Country's operating expenditure per kgMS is very low, again indicating that it operates nearer the commodity end of the market.

Revenue per kgMS, 2014-2019, $



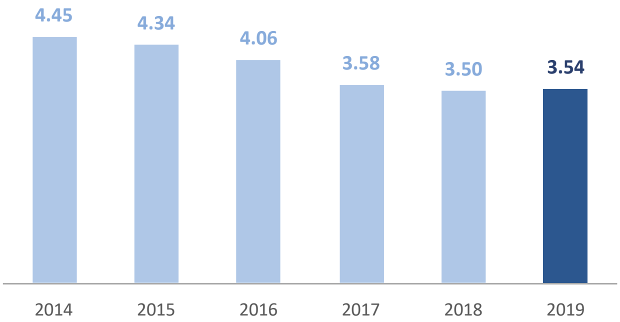
Revenue per kgMS of $9.61 indicates that Open Country operates nearer to the commodity end of the market. That said, it has been able to successfully generate additional value-add revenue in the last financial year with revenue per kgMS increasing while the commodity price was decreasing.

EBITDA per kgMS, 2014-2019, $



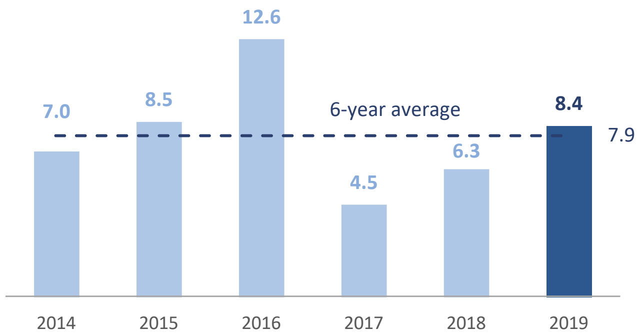
EBITDA per kgMS is low in an absolute sense but good relative to the amount of capital employed and the amount of risk being taken by the company. Operating nearer the commodity end of the market is low risk relative to the value-add end.

Capital employed per kgMS, 2014-2019, $



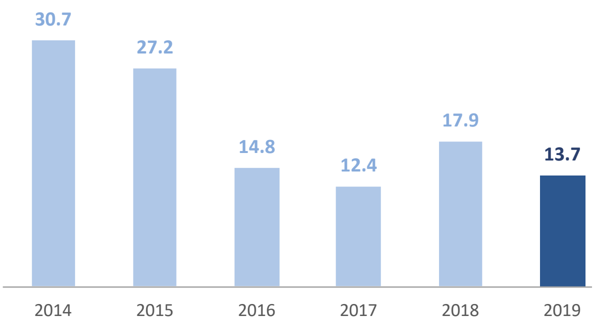
Capital employed has decreased relative to production as the company has applied profits to repay debt.

Return on capital employed, 2014-2019, %



Open Country's ROCE of 8.4% in FY2019 was better than its six-year average of 7.9% and significantly better than the two relatively poor previous years.

Leverage (net debt / net debt + equity), 2014-2019, %



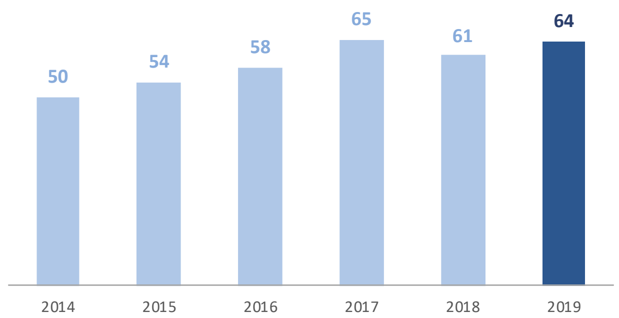
The company has a history of using debt to increase production capacity and then using profits to repay debt as quickly as possible.

Synlait

Synlait produces infant formula products, adult nutrition products, fresh dairy products and ingredients.

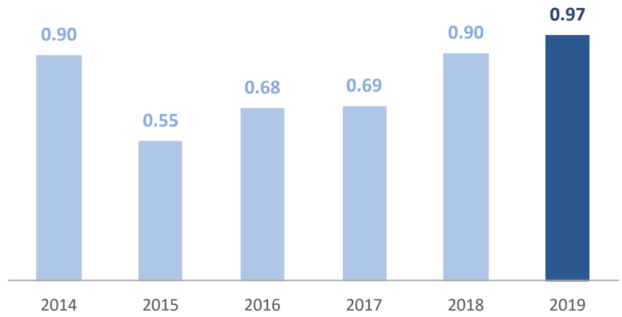
Synlait has recently released its FY2020 results. These have not been incorporated into the graphs but are discussed at the end of this section.

Volume, 2014-2019, kgMS millions



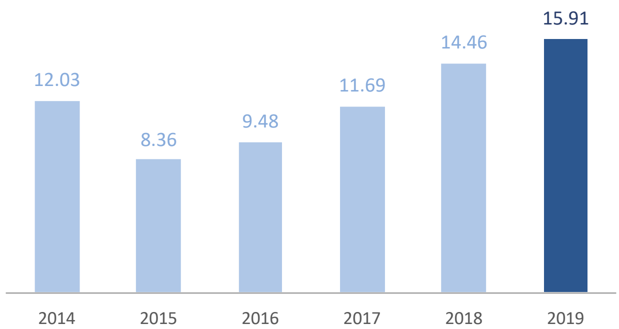
The volumes shown in the graph above are our best estimates. The estimated volumes represent just under 3.5% of New Zealand's total milk production.

Operating expenditure per kgMS, 2014-2019, $



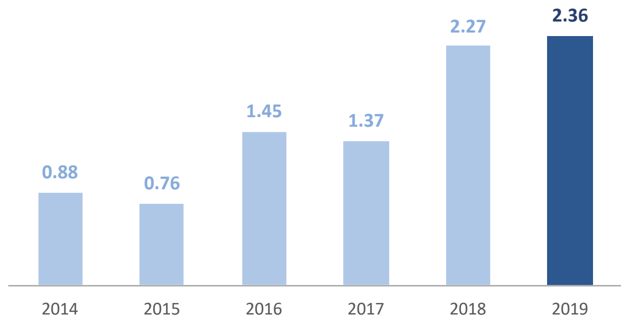
Although operating expenditure per kgMS has increased in the last year, it has done so at a slower pace than has revenue. We would expect operating expenditure per kgMS to increase as more value is added to Synlait's products.

Revenue per kgMS, 2014-2019, $



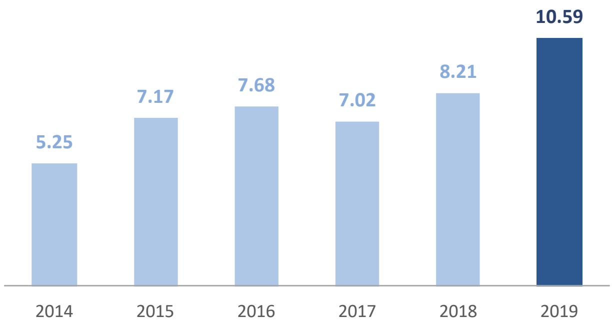
Increasing revenue per kgMS in a decreasing commodity price environment suggests that Synlait continues to add value to an increasing proportion of its total production.

EBITDA per kgMS, 2014-2019, $

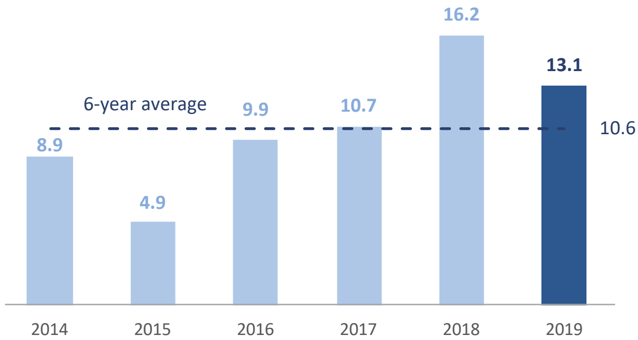


EBITDA per kgMS increased slightly but not by as much as expected with Synlait's cost of sales per kgMS increasing slightly year-on-year.

Capital employed per kgMS, 2014-2019, $



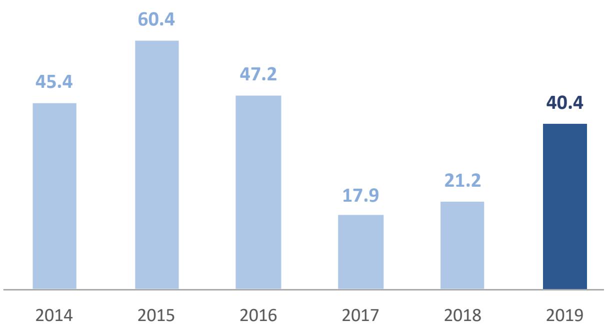
Return on capital employed, 2014-2019, %



Synlait's capital employed per kgMS increased significantly during the year as the company: started construction of a new plant in the North Island; completed the construction of a liquid milk facility in the South Island; and purchased a cheese company. The increase in capital employed per kgMS implies that Synlait currently has excess capacity. Total assets increased by over $350 million. The additional capital employed was in the form of both debt and equity.

EBIT increased year-on-year by approximately $13 million, but the company also invested significantly in additional assets hence the decrease in ROCE. That said, Synlait's ROCE was still comfortably above its six-year average of 10.6%.

Leverage (net debt / net debt + equity), 2014-2019, %



Debt was the major funding component of the increase in assets as is reflected in the company's balance sheet leverage. Net debt increased by approximately $200 million.

FY2020

Synlait collected 77 million kgMS in FY2020, an increase on the previous year of approximately 20%.

Its EBITDA / kgMS was $2.11, 10% less than the previous year as a consequence of the additional milk collected rather than lower EBITDA.

Balance sheet leverage increased again to 46%, with total assets increasing by another $350 million. Total assets have almost doubled in the last two years.

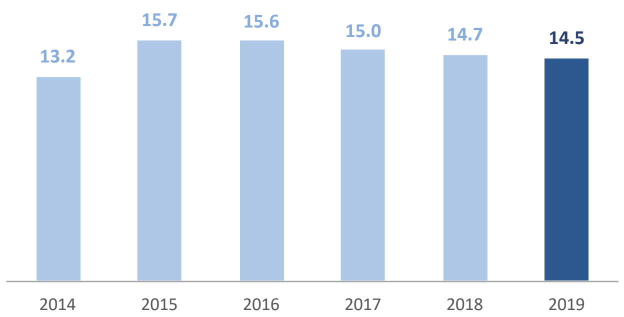
ROCE was 7.9%, which is a poor result for Synlait given its historical performance and probably indicates that the new assets were significantly under-utilised.

Tatua

Tatua manufactures, markets and sells specialised dairy ingredients and food products. Its specialised dairy ingredients are used in infant and medical nutrition, sports and lifestyle nutrition, and food and beverage manufacturing worldwide.

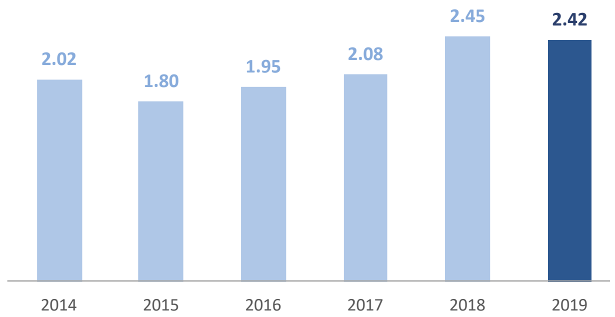
Tatua's dairy products are manufactured, marketed and sold to food and beverage manufacturers, hotels, restaurants and cafes, bakeries, fast food outlets and in supermarkets.

Volume, 2014-2019, kgMS millions



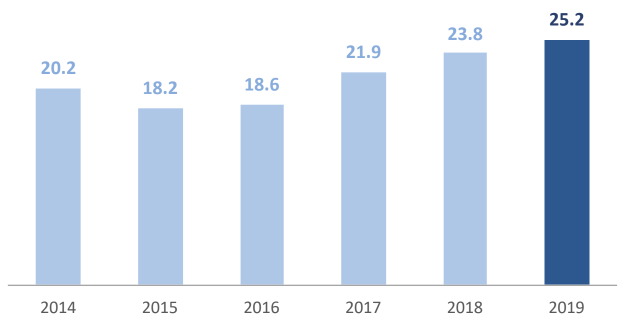
The volumes shown in the graph above are our best estimates. This estimated volume represents less than 1.0% of New Zealand's total milk production. It is interesting to note that Tatua's volumes have remained largely static while most other independent processing companies have increased volumes processed. Static volumes are likely to be a deliberate strategic decision, as the company would have little problem attracting new milk.

Operating expenditure per kgMS, 2014-2019, $



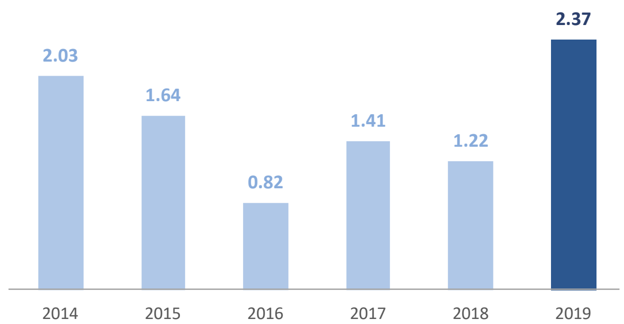
Given the company's value-add focus and the cost associated with supporting that focus versus commodities, it is not surprising that Tatua's operating expenditure per kgMS is also more than any other dairy company in New Zealand.

Revenue per kgMS, 2014-2019, $



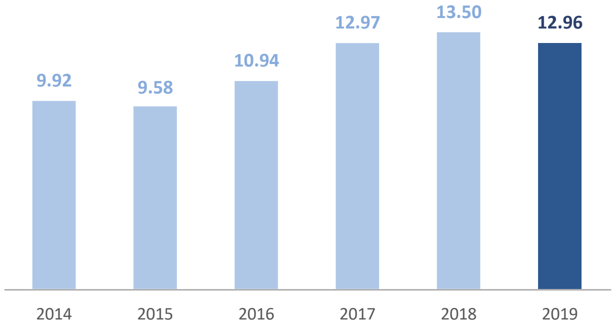
Tatua generates more revenue per kgMS sold than any other dairy company in New Zealand. Its revenue generating ability reflects the company's focus on value-add products.

EBITDA per kgMS, 2014-2019, $



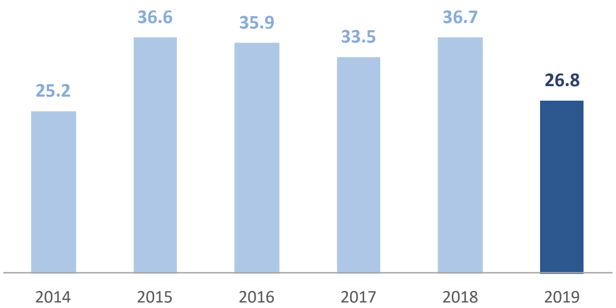
FY2019 was an excellent year for Tatua. It managed to drive higher revenue per kgMS during a period in which commodity prices fell, it managed to slightly increase its gross margins, and it managed to contain its operating expenses. All of which led to a higher EBITDA per kgMS while at the same time it paid its farmers $2.15 more than the FGMP for their milk.

Capital employed per kgMS, 2014-2019, $



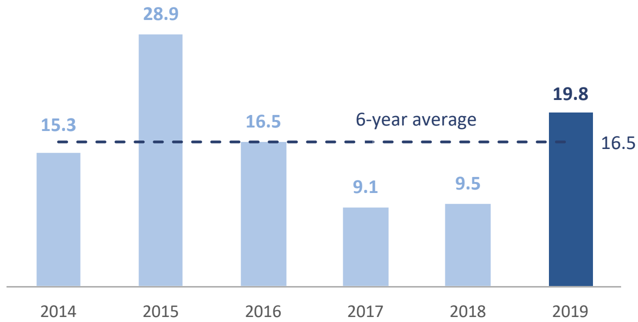
Capital employed of $12.73 per kgMS is more than most of the other milk processing companies in New Zealand but is only approximately two thirds of what both Mataura and Oceania have employed. The difference is probably a function of the relative age of the plants, with Tatua's plant older than that of Mataura and Oceania. Tatua's capital employed over the last couple of years has decreased slightly as the amount of equity employed has remained relatively static while debt has been reduced.

Leverage (net debt / net debt + equity), 2014-2019, %



Net debt decreased significantly in FY2019. Tatua's leverage is low relative to the industry.

Return on capital employed, 2014-2019, %



Tatua's ROCE has been calculated on a milk-price-adjusted basis. Tatua pays its suppliers more for their milk than any other milk processor and over the last six years has paid on average $1.50/kgMS more than Fonterra did.

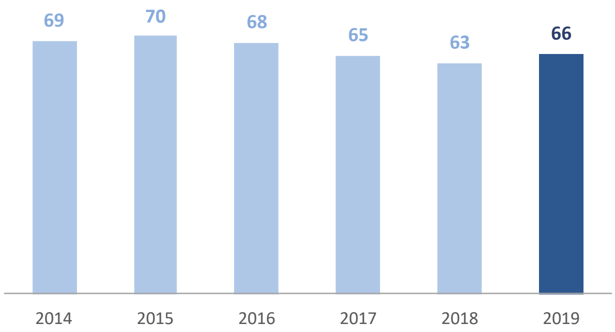
FY2017 and FY2018 were relatively low as a result of commodity prices increasing strongly, having been very low in the previous two years. Unless value-add product prices can be increased at the same pace, as commodity price increases margins get squeezed. However, in an environment in which value-add product price increases have been achieved and commodity prices are reasonably stable, normal operating margins can be re-established as per FY2019.

Westland

Westland produces ingredients, nutritional products and consumer and food service products.

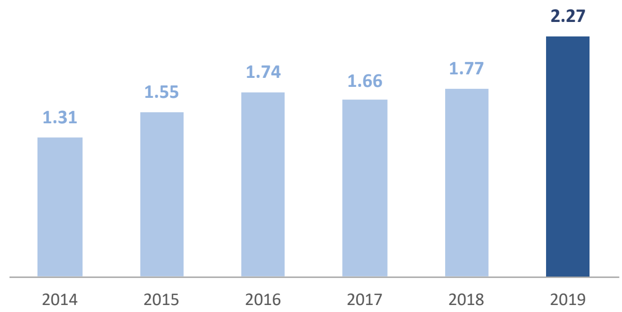
Until 31 July 2019, Westland was a farmer owner co-operative.

Volume, 2014-2019, kgMS millions



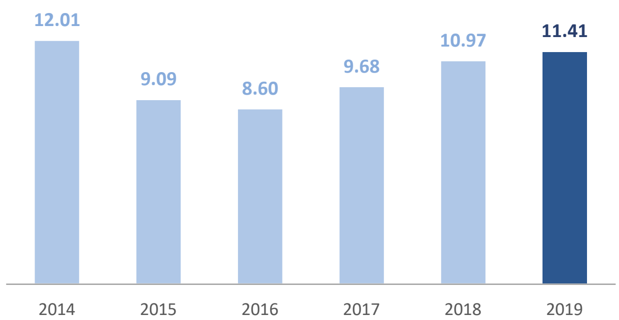
The volumes shown in the graph above are our best estimates. This estimated volume represents 3.5% of New Zealand's total milk production.

Operating expenditure per kgMS, 2014-2019, $



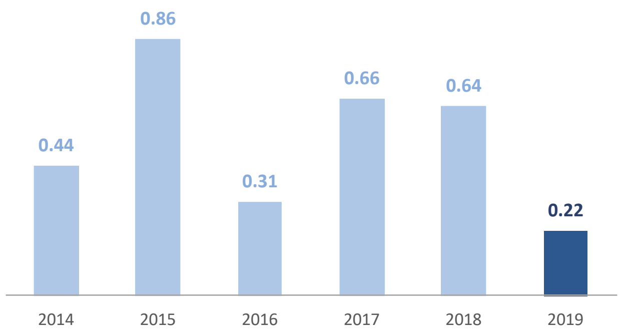
Given its revenue per kgMS, operating expense per kgMS of $2.27 is very high. A large proportion of the year-on-year increase was incurred as a consequence of a corporate restructure of the company. That said, excluding the one-offs still leaves Westland with high operating expenses per kgMS.

Revenue per kgMS, 2014-2019, $



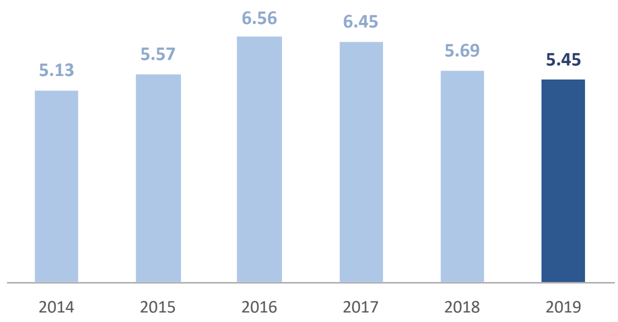
Westland increased its revenue per kgMS in a period of declining commodity price, suggesting that value was added to a larger proportion of its total production. However, revenue of $11.41 per kgMS indicates that a large majority of its production is sold at the commodity end of the market.

EBITDA per kgMS, 2014-2019, $



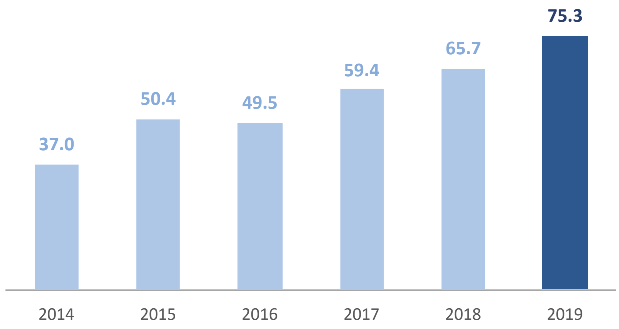
The lower year-on-year EBITDA can be attributed to the additional operating expenses discussed above. Westland's EBITDA would have been negative had it paid its suppliers the same for their milk as did Fonterra. Over the last six years, Westland paid its farmers on average $0.64 less for their milk than Fonterra did.

Capital employed per kgMS, 2014-2019, $



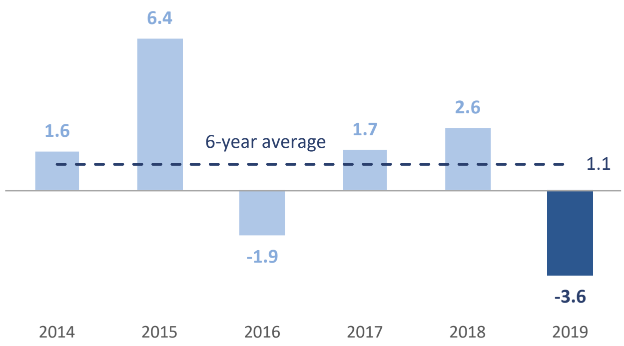
Westland has a relatively low amount of capital employed per kgMS, indicating that the majority of its production is nearer the commodity-end of the market. While the total amount of capital employed decreased marginally over the year, the components changed materially. Net debt increased to fund operating losses and asset purchases.

Leverage (net debt / net debt + equity), 2014-2019, %



As mentioned above, the increase in debt during FY2019 meant that Westland was relatively highly leveraged at year end.

Return on capital employed, 2014-2019, %



As poor as Westland's ROCE has been on average over the last six years, it has been overstated to the extent that the company paid its suppliers less than the FGMP for their milk in all but one of those years.


Imagery by Hugh Chesterman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