

Fonterra opens engine room door

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FONTERRA has explained in detail to institutional investors how it adds value to dairy commodities, generates the bulk of its revenue and earnings and keeps government regulators happy by using a Milk Price Model for reference products.

Senior executives passed the baton at an investors' briefing in Auckland, expounding on aspects of operations, financial reporting and growth strategy in what they called the engine room of the giant co-operative.

Chief financial officer Lukas Paravicini began by saying Fonterra was the world's largest dairy processor and the world's largest dairy product exporter. It had 17% market share of global exports, including 48% of whole milk powder and 39% of butter.

Fonterra's modern word for commodities, ingredients, accounted for two-thirds of normalised earnings, being \$1.2 billion last financial year.

About 95% of those ingredients earnings came from New Zealand operations with only minor contributions from Australia and Latin America.

In the 2016 financial year ingredients made a 13.4% return on capital, compared with 9.3% the previous year.

From milk collection and processing optimisation, contracts with customers for specifications and supply terms, followed by production to plan with minimum costs and maximum qualities and subsequent storage and shipments, Fonterra maximised its ingredient returns, Paravicini said.

In FY2016 the ingredients division had exceeded the Milk Price Model benchmark by 30% in revenue of \$11.8b, by 70% in gross margin of \$1.7b and by 75% in normalised Ebit for NZ operations of \$1.14b.

On track to meet our 2025 ambition

Make a difference in the lives of 2 billion people by 2025

OUR 2025 AMBITION

30 billion
LITRES
3-4 litre milk
pools

\$35
BILLION
TURNOVER

NO.1
INGREDIENTS
INCIDENTS

No.1 or 2
CONSUMER
BUSINESS
STRONG MARKETS
SUPPORTED BY FOOD SERVICES

TOP3
REPUTATION
STRONG BRANDS

WORLD
CLASS
ENGINEERING

With our purpose, strategy and values at the heart, our this is Fonterra framework brings together our people, identity and strategy commitments to guide us to be the world's most trusted source of dairy nutrition.

THIS IS FONTERRA

- 1 OPTIMISE**
New Zealand milk
- 2 BUILD AND GROW**
beyond our current consumer positions
- 3 DELIVER**
on food service potential
- 4 GROW**
our Andrew's business
- 5 DEVELOP**
leading positions in production and material nutrition
- 6 SELECTIVELY INVEST**
in milk pools
- 7 ALIGN**
our business and organisation



OUR IDENTITY

Creating long-term value for our farmers and communities

Top 3
Innovation
in Food Safety
and Quality
Management
2016

Making trusted dairy nutrition accessible to the world
Leading in food safety, quality and dairy regulatory
Championing the health of farms, networks and communities

OUR PEOPLE

empowering, part of one team

**World's Best
Dairy
Company
2016**

Caring for our people, farmers and customers
Trustful, open and engaging leaders
Growing our people, continuously improving, investing for the future

OUR VALUES

Our Values are our guide and underpin how we do business

CO-OPERATIVE SPIRIT

DO WHAT'S RIGHT

CHALLENGE BOUNDARIES

MAKE IT HAPPEN

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By disclosing those figures, Fonterra showed it was delivering added value to dairy commodities – hence the ingredients name – and that it exceeded the performance of a theoretical competitor, to justify its special position of industry dominance under NZ legislation.

Factors that were part of the added-value premium included timing of sales, asset flexibility, customers' willingness to pay more, the product mix, operating performance and the ability to arbitrage.

Paravicini said reference commodity products (RCPs) made up 72% of the 2.7 million tonnes of

ingredients manufactured in NZ in FY2016.

They were milk powders and some cream products versus non-RCPs like cheese, casein and milk protein concentrate.

The non-RCP products could range between 25% and 45% of total ingredients production within the year and year-by-year.

Last financial year non-RCPs achieved \$2.30/kg gross margin compared with 59c for RCPs and together the average was \$1.10/kg versus only 64c indicated by the Milk Price Model.

The worldwide milk pool strategy was in place to enable growth of ingredients to satisfy

growing consumer demand, secure continued access in Sri Lanka and China, de-risk supply for ingredients customers and provide opportunities for food service.

Through asset flexibility, product optimisation and the use of futures markets, Fonterra could make higher sustainable earnings that would be more difficult for its competitors to match, Paravicini said.

NZ Milk Products sales and transformation director Josh Sigmund said product optimisation was done over a continuously advancing 18-month time frame, from strategic, to

tactical, to operational at the shortest end.

The factors were commodity prices and stream returns, the NZ milk production supply, the NZ processing asset footprint and customers' needs.

Essentially, it was allocating the total solids in milk (14%, including protein, fat, lactose and minerals) into the highest value product streams.

Greater optionality was possible on the shoulders of the milk supply season.

Global operations chief operating officer Robert Spurway

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said 96 primary plants across 33 sites accounted for 50% of the costs of total global operations of \$3.7b last financial year, equivalent to \$2.47/kg of milk solids handled.

Milk collection was an additional \$400m, secondary processing \$700m and shipping costs \$500m.

The main focus was on widening the gap to the Milk Price Model but strategic decisions had been made to take on more cost to produce more non-RCPs or add value to RCPs.

Large capital expenditure to add overall capacity had now finished and this financial year significantly reduced spending was focused on investing for returns, environmental reasons and for just staying in business.

NZMP chief operating officer Kelvin Wickham said his segmented customer base included powders for repackaging, beverages and cultured brands, foods that used dairy as a key ingredient, active nutritional products and paediatric products.

His large team around the world had a proven record in navigating volatility, building markets and innovation and was earning premiums for product and service differentiation above the reference prices.