Market Announcement

26 SEPTEMBER 2019

FONTERRA ANNOUNCES FY19 ANNUAL RESULTS AND NEW STRATEGY

- Total Cash Payout for 2018/19 season: $6.35
  - Farmgate Milk Price $6.35 per kgMS
  - Dividend of 0 cents per share
- New Zealand milk collections: 1,523 million kgMS, up 1%
- Normalised sales revenue: $20.1 billion, down 2%
- Net loss after tax: $605 million, compared to a loss of $196 million
- Normalised EBIT: $819 million, down 9%
- Normalised gross margin: 15%, down from 15.4%
- Normalised operating expenses: $2,311 million, down 7%
- Capital expenditure: $600 million, down 30%
- Normalised Return on capital: 5.8%, down from 6.3%
- Free cash flow: $1,095 million, up 83%
- Normalised earnings per share: 17 cents
- Gearing ratio: 48.2%, down 0.2%
- FY20 forecast Farmgate Milk Price: $6.25-7.25 per kgMS
- FY20 forecast earnings per share range: 15-25 cents
- New strategy, operating model and changes to management team announced

Today Fonterra announced its FY19 annual results, the final milk price for the 2018/19 season, its refreshed strategy and changes to its operating model and management team.

The Co-operative reports a Net Loss After Tax of $605 million. Normalised earnings before interest and tax (EBIT) was $819 million, down 9%, the Co-operative's free cashflow was $1,095 million, up 83%, and the return on capital was 5.8%, down from 6.3%.

Fonterra CEO Miles Hurrell says that 2019 was incredibly tough for the Co-op but it was also the year Fonterra made decisions to set it up for future success.

"These included us reflecting changing realities in asset values and future earnings, lifting our financial discipline, getting clear on why we exist and completing a strategy review.

"Many of these calls were painful, but they were needed to reset our business and achieve success in the future.

"We made the decision to reduce the carrying value of several of our assets and take account of one-off accounting adjustments. These totalled $826 million, which contributed to a Net Loss After Tax of $605 million for FY19.

"As we do every year, we took a hard look at our asset valuations and future earnings potential. When it came to DPA Brazil, Fonterra Brands New Zealand and China Farms, we saw there were either some changes in their local economies, increased competition or business challenges impacting their forecast earnings. This meant we needed to reduce their carrying value.

"Clearly, any write-down of an asset is not done lightly. But what I hope people can also see is that we're leading the Co-op with a clear line of sight on potential opportunities as well as the risks."

Commenting on the underlying performance of Fonterra, Mr Hurrell said Fonterra's normalised earnings per share for the year was 17 cents, which was above the last forecast for the year of 10-15 cents.

"The gross margin from our largest business, New Zealand Ingredients, was $1,332 million, up 3% on last year due to increased sales and price performance.

"Our Foodservice performance also improved on last year, with gross margin up 10%. This was despite lower total sales volumes, following a slow start to butter sales in Greater China and Asia.

"But we can't ignore that we had a number of challenges across the year – these included Australia Ingredients, our businesses in Latin America and the consumer businesses in Sri Lanka, Hong Kong and New Zealand.

In September 2018 Mr Hurrell set out a three-point plan – take stock of the business, get basics right and ensure more accurate forecasts. Reflecting on that plan, he said that it definitely helped focus the Co-op. "I'm pleased with the progress we've made with our financial discipline. You can see it in our improved cashflow, reduced debt and significant cost savings.

"As part of taking stock of our business we reviewed our asset portfolio and made significant calls on three assets we identified as no longer core to our strategy. We sold Tip Top for $380 million and our share of DFE Pharma for $633 million. We also wound back our relationship with Beingmate and are now looking at options to reduce our financial stake in this company.

"Taking stock of our business didn't stop there. We also exited our Venezuela businesses, announced the closure of our Dennington manufacturing site in Australia and kicked off a strategic review of DPA Brazil and two of our farm-hubs in China.

"We have contributed to China's dairy industry by developing high quality model farms. We made these investments as they were seen as necessary to protect our significant exports to China. Growing demand for fresh milk in China's consumer market suggests prices are likely to rise in the future – however, the timing is uncertain. As a result of this, and the fact that the development of these farms is now complete, we are looking at how we can best unlock the value in the farms.

"This sort of discipline around reviewing our asset portfolio isn't a one-off. We need to be continuously reviewing our assets and making sure they are meeting the changing needs of our Co-op.

"As part of the three-point plan, we also set a goal in FY19 to reduce our debt by $800 million. Tip Top made a significant contribution and, along with the sale of DFE Pharma, we expect to exceed this target in FY20.

"We also set ourselves a target to reduce capital expenditure by $200 million in FY19 and we achieved $261 million. We reduced our operating expenses by $185 million, year on year.

Final Farmgate Milk Price for the 2018/19 season

Fonterra announced a final Farmgate Milk Price for the 2018/19 season of $6.35 per kgMS.

Fonterra Chairman John Monaghan said this was the third year of sustainable prices and represented $9.7 billion for milk payments to the Co-op's farmer owners in the 2018/19 season.

Global prices for whole milk powder, butter and anhydrous milk fat were weaker compared to last year. This was driven by excess supply relative to demand, particularly for whole milk powder, for much of the season. Skim milk powder prices, however, were stronger.

The refreshed strategy and FY20 earnings guidance

Mr Hurrell said the final big call for the year has been sharing the Co-op's new strategy.

"It's a strategy which recognises we are a New Zealand co-op, doing amazing things with New Zealand milk to enhance people's lives and create value for customers and farmers. It's a strategy that's rich in innovation, sustainability and efficiency. It unlocks value and sees us focusing on three goals – healthy people, healthy environment and healthy business.

"This is the right strategy for us, but it requires us to make some hard choices. We've looked at the big opportunities and risks for a New Zealand dairy co-op today. We've also got clear on what our strengths are and the hard realities we have to face up to. I'm pleased that we now have a strategy that is built from the belief that our farmers' milk here in New Zealand is the best and most precious in the world.

"Recognising this, while we will complement our farmer owners' milk with milk components sourced offshore when required, we will start rationalising our off-shore milk pools over time.

"Our strategy will see us focus on world-class dairy ingredients for our customers around the world, and innovative ingredients that meet nutrition needs right across people's life stages. We will focus on ingredient categories: Paediatrics, Medical and Ageing, Sports and Active, and Core Dairy.

"We will also create new opportunities in new ways for foodservice. This will include building on our foodservice success in China and developing new markets, particularly in Asia Pacific.

"This focus on dairy ingredients and foodservice will see us playing to our strengths and driving more value from the parts of our business that consistently perform.

"We will still be in Consumer and will focus on markets throughout Asia Pacific. The majority of the products we sell in these markets are made from New Zealand milk and are similar to those we sell in our Ingredients business. This creates efficiencies and helps us play to our strengths. It also means we will reduce our consumer product portfolio to those that create superior value."

Mr Monaghan said the new strategy sounds simple but the best strategies often are.

"Simplicity shouldn't be confused with a lack of ambition. Our forecast earnings range for FY20 starts at 15-25 cents per share, but the five-year plan is to deliver a target of 50 cents per share.

"Our starting earnings range reflects our change in culture. We will earn the right to make ambitious decisions by first doing the basics right and returning our balance sheet to a position of strength. That will give us options to go for the opportunities that we create in the future."

As announced at half year, the Board reviewed the Dividend Policy guidelines within the context of the new strategy. Mr Monaghan says the new guidelines better reflect the annual performance and financial strength of the Co-operative.

"Under the new guidelines, we would expect the dividend payment to be 40-60% of reported Net Profit After Tax, excluding any abnormal gains, from what was previously 65-75% of adjusted Net Profit After Tax over a period of time. An interim dividend will not be more than 40% of the forecast total dividend and no more than net earnings at half year.

"In addition to the new percentage of earnings, two additional key principles will guide our Board when considering the payment of a dividend. A dividend should not require our Co-op to take on more debt, and a dividend should not reduce our Co-op's ability to service existing debt.

"The distribution of any abnormal gains, such as an asset sale, will be considered separately," he says.

New operating model and changes to the management team

One of the immediate priorities for the Co-operative is organising itself to best deliver the new strategy. Mr Hurrell said he is introducing a new customer-led operating model.

"We need an organisational structure that allows us to live within our means, create better connections with our customers, create value by focusing on what we are good at, and where we can differentiate ourselves. The structure encourages us to work together as one team.

"Our new operating model will see us move from our two large, central businesses (Ingredients, and Consumer and Foodservice) to three in-market customer facing sales and marketing business units – Asia Pacific (APAC), Greater China (GC), and Africa, Middle East, Europe, North Asia, Americas (AMENA).

"We are creating a new team (office of the Chief Operating Officer) which will be the enabler for our in-market business units to create value through sustainability, innovation and operational scale and efficiency.

"We are also looking at ways to prioritise activities and increase efficiency for our central support functions, ensuring they add direct value to our Co-op.

"These changes also mean there are changes in my lead team and I'm delighted to make the following appointments from my current team, which are effective immediately:

- APAC CEO – Judith Swales
- AMENA CEO – Kelvin Wickham

"Marc Rivers will remain our CFO, Deborah Capill our MD People and Culture and Mike Cronin our MD Co-operative Affairs

"It is with regret that I announce Robert Spurway has decided it's time for a change of direction in his career and will leave Fonterra after eight outstanding years with our Co-operative. Prior to joining Fonterra, Robert held several CEO positions and he now wants to fulfil his passion for directly running a business again.

"He has been a huge contributor to the ongoing strength and performance of our NZMP Ingredients business and has set the platform for continued success - through innovative technologies, a team of highly capable people and significant progress on sustainability across our manufacturing operations - all central to our strategy.

"Over the next few months Robert will help transition Global Operations to the new operating model as well as working with the Greater China leadership team to implement the new Greater China regional go-to-market model.

"I have recruitment processes underway for the China CEO and Chief Operating Officer.

"I look forward to working with this team and the wider Fonterra team to move forward and reset the Co-op. Our priorities in our first year of our new strategy will be to build a winning team, support regional New Zealand, reduce our environmental footprint and hit our financial targets."

Non-GAAP financial information

Fonterra uses several non-GAAP measures when discussing financial performance. These measures include normalised segment earnings, normalised EBIT, EBIT, normalised earnings per share, normalisation adjustments and payout. These are non-GAAP financial measures and are not defined by NZ IFRS. Management believes that these measures provide useful information as they provide valuable insight on the underlying performance of the business. They are used internally to evaluate the underlying performance of business units and to analyse trends. These measures are not uniformly defined or utilised by all companies. Accordingly, these measures may not be comparable with similarly titled measures used by other companies. Non-GAAP financial measures should not be viewed in isolation nor considered as a substitute for measures reported in accordance with NZ IFRS. These non-GAAP measures are not subject to audit unless they are included in Fonterra's annual financial statements.

Definitions of the non-GAAP measures used by Fonterra, and reconciliations of the NZ IFRS measures to the non-GAAP measures can be found on pages 113 to 115 of Fonterra's Annual Report that is available on Fonterra's website.

-ENDS-

For further information contact:

Fonterra Communications
24-hour media line
Phone: +64 21 507 072