REFINITIV STREETEVENTS

PRELIMINARY TRANSCRIPT

FSF.NZ - Preliminary 2020 Fonterra Shareholders' Fund Earnings Call

EVENT DATE/TIME: SEPTEMBER 18, 2020 / 1:30AM GMT

CORPORATE PARTICIPANTS

Marc Rivers *Fonterra Co-operative Group Limited - CFO*

Miles Hurrell *Fonterra Co-operative Group Limited - CEO*

PRESENTATION

Miles Hurrell *- Fonterra Co-operative Group Limited - CEO*

Hi, everyone. Welcome to our annual results presentation for 2020. I'm joined here today by our CFO, Marc Rivers. Firstly, I'd like to acknowledge the great work that has gone on by our teams to manage what has been an unprecedented situation through COVID. The hard work and resilience and help juggling the demands of COVID has certainly helped us in delivering this performance today.

Let's start with the net profit after tax, an increase of [$1.3 billion] to $659 million, which goes a long way to delivering upon all our promises we've set out at the start of the year. In addition to our earnings, we've also had a higher milk price delivering $7.14 kilogram of milk solids for the year just finished, which puts about $11 billion into the economy.

When I look from an environmental perspective, hitting our 2020 energy intensity target, which was set in 2003 is something we're also very proud of. Our underlying business performance has improved.

Normalized NPAT was up $118 million to $382 million, being $0.24 per share, being at the top end of our guidance range. Also reduced our economic net debt by $1.1 billion. This is important to delivering equipment to reduce our leverage and strengthen our balance sheet.

On top of delivering our performance for the year and our priorities, we've also announced the dividend this morning of $0.05 per share to be paid on 15th of October. This will achieve while navigating the global pandemics through the second half of the year. So while Marc will take us through the details, I briefly want to touch on how we've responded through COVID.

It's undoubtedly a tough environment for most. And the global dairy market has brought increased volatility and uncertain. But despite this, we've performed well. As an essential business, we continue to operate through the lockdown. The health and safety of our people was paramount and our #1 priority. And our teams around the world are all at different stages of managing COVID. And we've also been providing our people clarity on what the cap is up to. This has meant they know what they need to do to minimize the risk of further spread while ensuring our business continues to operate.

The work done in the last 18 months to strengthen our balance sheet was timely and allowed us to focus on managing the COVID-19 situation. Many of our markets in which we do business are prone to sudden shocks and can impact we win and what we sell. However, the global nature covered is something we've never experienced before. So far, demand for dairy has proven resilient, and we're drawing on our global supply chain and using a diverse product and customer base to direct milk into those products and markets where the most value can be achieved. We remain agile, and we're doing everything to ensure we are prepared for any challenges that may arise through the global pandemic.

I'll now ask Marc to take us through some of the details.

m2=

Marc Rivers *- Fonterra Co-operative Group Limited - CFO*

Thank you, Miles. So our 2020 financial year really is a game of 2 halves, but we focused on what mattered, and that's reflected in the results. So if I sum up 2020, it'd be like this. Gross profit, up $200 million. Foodservice business had a very strong first half, driven by Greater China, but was then partially offset by the emergence of COVID in the second half. Balancing this, our ingredients business after having a stable first half benefited from favorable product pricing relativities between reference and nonreference during the second half and overall, had an improved performance relative to the prior year. So we came in at the top end of our normalized EPS range and included a number of adverse significant items that we did not normalize, and these reduced our normalized profit after tax by $104 million or $0.06 per share.

We've maintained our focus on strong financial discipline. So CapEx for the year was $419 million, which is $181 million, down from last year and $81 million below our target of not more than $500 million for the year. Total group normalized operating expenses reduced slightly. This is a good result, bearing in mind last year, benefited from not paying any employee performance incentives.

We also completed key asset sales in the first half of 2020 financial year of DFE Pharma and foodspring, and they generated cash proceeds of $623 million and a gain on sale of $467 million. They contributed to a significant reduction in our debt and strengthening our balance sheet.

Our return on capital has improved from 5.8% to 6.7%, and the improvement came from a result really of increased earnings as well as lower capital employed. So all of our group financial metrics have improved.

Let me just go over the things we've not covered off yet. Our total group sales revenue increased 5% or $1.1 billion to $21 billion, and that's driven by improved ingredients pricing as well as product mix. But also worth noting greater China Foodservice business, which contributed an additional $166 million in revenue in spite of the disruption from COVID.

Our normalized EBIT increased $67 million or 8% to $879 million, and the approved performance from ingredients and Foodservice both contributed to that increase. Free cash flow increased by $733 million to $1.8 billion, and we achieved that through the improved earnings, lower capital expenditure as well as the sales proceeds from divesting DFE Pharma and foodspring as well as the reduction that we've been making gradually on our Beingmate shareholding.

Our main measure of leverage is the ratio of the debt to EBITDA, which improved from 4.4x to 3.4x, and that's well below our target of 3.75 for the year. This year marks a return to paying dividends, a position we expect to maintain in the future, assuming normal operating conditions. And at $0.05 per share, the dividend is at the lower end of the $0.05 to $0.07 range. That's calculated under our Board's dividend policy guidelines.

And during the context of so much uncertainty as COVID-19 continues to impact our key markets and customer confidence, distributing a $0.05 dividend is a prudent decision and one that balances our aims of further reducing debt and distributing earnings. We've come a long way from last year with a $1.2 billion improvement in profit after tax. And just note here referring to profit after tax attributable to equity holders, so after noncontrolling interest.

If we just start on the left, this time last year, we had a reported loss after tax of $562 million, and that included $826 million of impairments and other costs which after normalizing, resulted in FY '19's normalized profit after tax of $264 million. This year, our underlying business performance improved, with [$322] million of higher after-tax operating earnings. Key drivers to that improved performance were $200 million increase in gross profit, as I mentioned before. We've decreased our net finance cost 21% from $418 million to $332 million on the back of lower average debt and lower interest rates. Offsetting this improved operating performance were some adverse significant items of $104 million, and they included $57 million impairment of intangible asset values, one is a $36 million brand impairment on our [Chessell] brand. This is shared between our Greater China and Asia consumer businesses. And the other was a $21 million goodwill impairment on New Zealand consumer business. There's also a $28 million provision for a potential payment relating to holiday pay. This is pending judicial interpretation of the requirements of legislation in New Zealand.

And lastly, when we completed the closure of our German trading entity, we're required to release the related foreign currency translation reserve to the income statement, and that's an additional loss of [$19] million. So the net improvement to our normalized profit after tax was $118 million, with normalized profit after tax for the 2020 financial year of $382 million. This equates to $0.24 per share, an $0.08 improvement in normalized EPS compared to last year.

So in order to just show the underlying performance of the business, we also had some normalized items. We had positive normalized items of $549 million. The main ones coming from DFE, $427 million; foodspring, $66 million; and Beingmate, $50 million. Some negative normalized items totaled $245 million. The main ones are China Farms, $63 million; DPA Brazil, $45 million; and China farming JV, $65 million. So in total, normalized items were a net positive $304 million, and more detail is provided in the appendix of the presentation.

Including normalized items, our total group reported profit after tax attributable to equity holders is $686 million, and that equates to $0.43 per share.

We've moved to our new operating model in the course of the year, but we are reporting our segment performance on the same basis as the interim results. Next year, we'll report on the new operating model.

Looking at the business segment's performance. First of all, ingredients. The ingredients business had an improved performance. Total ingredients gross margin increased from 8.9% to 9.3%, thanks to favorable product mix and pricing in the second half of the financial year. This led to ingredients normalized gross profit increasing $165 million to $1.6 billion, with all 3 businesses contributing to that increase. New Zealand, up $131 million, thanks to favorable price relativities; Australia ingredients, up $22 million due to Dennington closure savings, better product mix and utilization on our Standhope site; and also Chile ingredients, which improved $13 million, thanks to improved product pricing.

Operating expenses increased 3%. That reflects the FY '19 benefit of no performance incentives. So we're left with EBIT from ingredients, from continuing operations, increasing $37 million or 5% to $827 million despite prior year. So this includes $44 million of earnings from now divested DFE in -- that was included in last year's results.

Foodservice also had improved performance. With its full year EBIT up 14% to $209 million, thanks to a very strong first half. EBIT in the first half was $148 million. EBIT in the second half reduced to $61 million due to the impact of COVID-19-related restrictions is particularly evident in the fourth quarter. The strong first half was driven by Greater China and Asia due to recovery and butter margins and selling more higher gross margin products, such as Anchor food professionals, whipping cream and cream cheese.

Within Greater China, COVID-19 impacted early in the third quarter, but rebounded quickly. During the fourth quarter, parts of China have still been impacted by COVID-19 outbreaks, which is hampered a complete recovery, but much closer to 100%.

Asia and the Oceania markets, however, were significantly impacted in the fourth quarter by the restrictions put in place to manage the pandemic. Our consumer business EBIT was down, however, it included $57 million of impairments that we did not normalize. The impairments are the ones I've already mentioned before and relate to Fonterra brands New Zealand and our Chessell brand. If we adjust for those impairments, our EBIT for the year is down $21 million and mainly due to the challenging market conditions that we experienced in Hong Kong and Chile.

Gross profit declined $77 million from Greater China, which is down $31 million because of the challenging market conditions in Hong Kong. Oceania gross profit reduced $26 million, mainly due to tiptop being included in last year's results. And of course, that's a business that we sold in the course of 2019. Not included in the consumer results is DPA Brazil, which is held for sale and meets the definition of a discontinued operation. However, DPA Brazil's EBIT increased $29 million due to a strong first half performance and growth in market share.

Excluding impairments and including discontinued EBIT, the consumer earnings is up $7 million on last year.

Miles Hurrell - *Fonterra Co-operative Group Limited - CEO*

Right. Thanks, Marc. Certainly a lot of information to take in, but we measure success through 3 interconnected goals, those being healthy business, healthy people and healthy environment. So in addition to the healthy business information that Marc's provided, I want to share our progress against a healthy people and a healthy environment metrics.

We've already mentioned $11 billion flowing into the New Zealand economy by way of milk price. But we also have supported things from a nutritional programs such as KickStart Breakfast, which celebrated its tenth year this year.

And during COVID-19, we also got stuck in and help communities and customers manage that pandemic such as redirecting 2 million liters of ethanol to support the use of hand sanitizer and also extending our production season at [Holt] app to support the hydrolysate business with some of our key customers offshore for those customers impacted by COVID.

If I look at the healthy environment side of the equation, we've also made good progress as we look to reduce our environmental footprint. The progress I talk about are regarding our energy efficiency targets. We've reduced our energy intensity across our manufacturing sites by 20% since our 2003 baseline. We've also looked to support our farmers with pharma environment plans up to 34% of our farmers will have a pharma environment plan this year, up 23% last year. And also farmers will be provided with a on-farm emission report, which will help them make their own decisions to support their sustainability journey.

But the big news this week we've also announced is the introduction of wood pellets into our Te Awamutu boiler, reducing our national coal use by around 10%.

If I look at our targets for the 2021 season here, I look at it through 3 lenses. Firstly, the cooperative where we need to continue to drive a strong milk price for our pharmacy holders, but also supporting our teams and empowering them to get on and make it happen. I think about performance continuing to drive our return on capital greater than 6%, continue to focus on our debt-to-EBITDA position to be no more than 3 to 3.5x and also looking to our earnings guidance for the year of $0.20 to $0.35.

If I start talking about the outlook for the year ahead, global dairy prices can be challenging to forecast at the best of times, and COVID adds significant uncertainty into the process of forecasting that will happen with global dairy prices over the coming year. With both increasing demand and increase in supply, we'll see dairy prices outlook as finally balanced in the year ahead, which is why we maintain our range of $5.90 to $6.90. We've also set our earnings guidance of $0.20 to $0.35. And it is difficult to predict movements in the global pandemic and whether we'll see a reemergence in our key trading markets. We're currently assuming lockdowns will ease in Greater China, and Asia markets will continue to improve. We're anticipating improved trading performance in Asia Pacific foodservice and consumer, particularly continued growth throughout Australia. We're not assuming the levels of favorable price relativities we received in the second half of the 2020 financial year will be repeated in the current year, and we've already seen these narrow. Offsetting the reduced pricing relativities is the assumption would have less adverse significant items and lower interest and tax expenses.

To conclude this part of the presentation, I'd like to say I'm proud of what the team has performed in the last financial year, and I believe we're well positioned to face 2021. Thanks for listening, and we're now happy to open for questions.