



Fortnightly Agri Update

3 June 2015

Dairying on the RBNZ's radar

World dairy prices remained under pressure in the latest GlobalDairyTrade auction. The overall index fell by 4.3%, and is now down almost 30% from its short-lived bounce in February. The result was disappointing given that other indicators of dairy prices, such as futures markets, had been hinting at some stabilisation in prices in recent weeks.

In the last *Fortnightly Agri Update* we noted that there were downside risks to our forecast of Fonterra's payout, and the latest auction result has forced us to act on that risk. We now expect a farmgate milk price of \$5.40/kg for the new season, down from \$5.70/kg previously. This is a little higher than Fonterra's opening forecast of \$5.25/kg, but both forecasts are contingent on an improvement in world prices over the course of the season. The conditions for such an improvement don't appear to be in place just yet.

It's been widely commented that two consecutive seasons of below-average milk prices will present a substantially greater challenge to dairy farmers than a single season of low prices would have. The Reserve Bank has been investigating the vulnerability of the dairying sector, and provided a snapshot of this work in its *Financial Stability Report* last month. (A more detailed paper is due to be published later this year.)

Using farm-level data provided by DairyNZ, the Reserve Bank estimated that about a quarter of dairy farms would experience negative cashflow in the 2014/15 season – that is, operating margins would be insufficient to cover interest (or rent) payments. The analysis was based on a farmgate milk price of \$4.50/kg, although deferred payments from the previous record season meant that cashflow was assumed to be closer to \$6.00/kg.

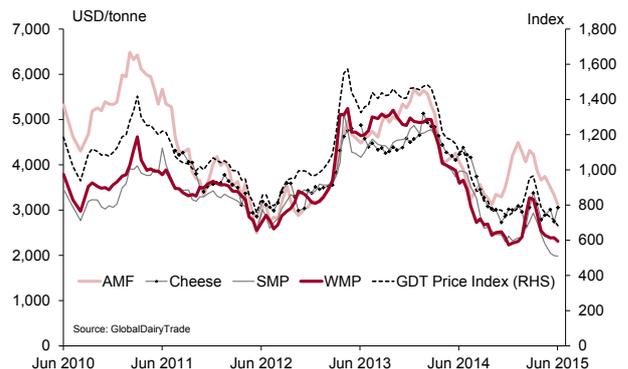
One of the most striking reasons for so many dairy farmers experiencing negative cashflow is the wide variation in operating efficiency. The RBNZ noted that the most profitable 10% of dairy farms have working expenses around \$2 per kilo of milksolids lower than the least profitable 10% of farms. The history of the dairy industry has been that the least efficient business practices tend to be squeezed out over time; the current low milk prices will provide a catalyst for this process.

The other notable factor behind in the variation in dairy farm costs – and where the RBNZ's focus comes in – is the degree of leverage. The RBNZ notes that 10% of farms account for about a third of the debt. Part of that skew reflects the fact that these 10% of farms tend to be larger, with more assets and more milk production backing the debt. But even so, these farms also tend to be the most leveraged, with average debts exceeding \$25 per kilo of milksolids produced. Notably, the most leveraged dairy farms also appear to be the least profitable – though this may be due to farmers structuring their business to minimise taxable income, taking their gains in the form of rising land prices instead.

The RBNZ notes that low milk prices would be a particular concern if they were accompanied by a fall in farmland prices, which would constrain farmers' ability to borrow against their equity buffer. That hasn't been the case to date – in fact, land prices have been surprisingly perky, with the REINZ's dairy farm price index up about 15% on a year ago.

On top of the dairying sector's current cashflow concerns, there's a risk that financing conditions could tighten. *The Financial Stability Report* was silent on what action would the RBNZ take if it believed the dairying sector was becoming a threat to financial stability. But we think the most likely response is that the RBNZ would require banks to hold a larger capital buffer against their existing agricultural loans, to absorb an expected rise in defaults. If so, the cost of holding that additional capital buffer would be factored into the interest rates for farm lending.

GDT auction prices



GlobalDairyTrade Auction Results, 3 June

	Change since last auction	Price USD/Tonne
Anhydrous Milk Fat (AMF)	-7.4%	\$3,112
Butter Milk Power (BMP)	-7.0%	\$1,795
Butter	-10.0%	\$2,619
Skim Milk Powder (SMP)	-1.3%	\$1,982
Whole Milk Powder (WMP)	-3.1%	\$2,309
Cheddar	7.6%	\$3,055
GDT Price Index	-4.3%	

Payout Forecast Table

	2013/14 - Final	2014/15		2015/16
	Fonterra	Fonterra	Westpac	Westpac
Milk Price	\$4.40	\$4.40	\$5.25	\$5.40

Michael Gordon Senior Economist

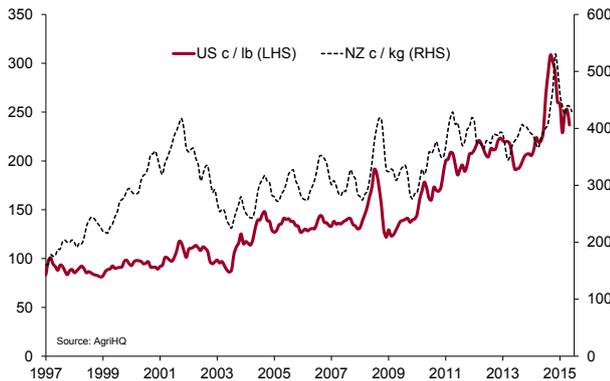
Beyond the farm gate



Beef

	Current price level compared to 10 year average	Next 6 months
Trend	Above Average	→

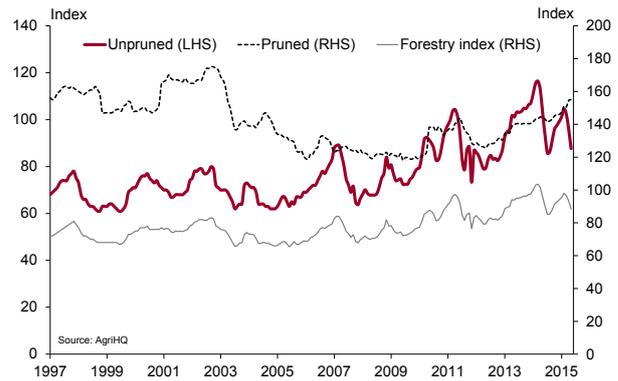
US beef prices remain high, although well off last year's peaks as demand is now being well serviced by supply from Australia and New Zealand. The early cull as a result of the dry summer is now having an inverse effect on slaughter numbers, which were about flat on year-ago levels in March and April.



Forestry

	Current price level compared to 10 year average	Next 6 months
Trend	Average	↘

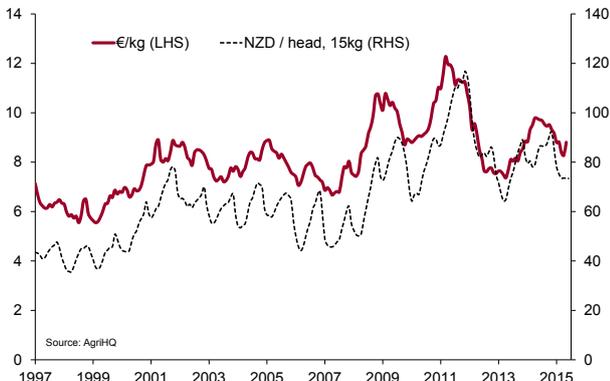
Export log prices have fallen sharply again in recent months, as excess stocks have built up at Chinese ports and the weaker ruble has made Russian logs more competitive. In contrast, domestic log prices have risen further. Demand for housing construction materials continues to grow, although quake-related activity in Christchurch is expected to peak this year.



Lamb

	Current price level compared to 10 year average	Next 6 months
Trend	Average	→

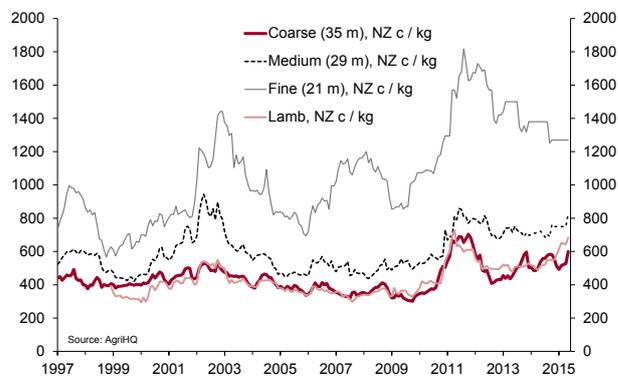
Good growing conditions in the UK, Europe and China mean that the global supply of lamb is likely to remain plentiful this year. The dry summer in New Zealand probably had less of a depressing effect on prices than initially feared: lamb slaughter numbers spiked in January, but have been significantly below year-ago levels since then.



Wool

	Current price level compared to 10 year average	Next 6 months
Trend	Above Average	→

Wool prices have remained resistant to competition from oil-derived synthetic materials to date. Lambs' wool has been the standout, with growing demand from China in the last year; this has been joined by significantly stronger prices for most other grades in recent weeks.



NB: Trend arrows indicate direction of change in world prices.

Westpac economics team contact details

Dominick Stephens, Chief Economist
+64 9 336 5671

Michael Gordon, Senior Economist
+64 9 336 5670

Felix Delbrück, Senior Economist
+64 9 336 5668

Satish Ranchhod, Senior Economist
+64 9 336 5669

Any questions email:
economics@westpac.co.nz

Disclaimer

Things you should know: Each time someone visits our site, data is captured so that we can accurately evaluate the quality of our content and make improvements for you. We may at times use technology to capture data about you to help us to better understand you and your needs, including potentially for the purposes of assessing your individual reading habits and interests to allow us to provide suggestions regarding other reading material which may be suitable for you.

If you are located in Australia, this material and access to this website is provided to you solely for your own use and in your own capacity as a wholesale client of Westpac Institutional Bank being a division of Westpac Banking Corporation ABN 33 007 457 141 AFSL 233714 ('Westpac'). If you are located outside of Australia, this material and access to this website is provided to you as outlined below.

This material and this website contain general commentary only and does not constitute investment advice. Certain types of transactions, including those involving futures, options and high yield securities give rise to substantial risk and are not suitable for all investors. We recommend that you seek your own independent legal or financial advice before proceeding with any investment decision. This information has been prepared without taking account of your objectives, financial situation or needs. This material and this website may contain material provided by third parties. While such material is published with the necessary permission none of Westpac or its related entities accepts any responsibility for the accuracy or completeness of any such material. Although we have made every effort to ensure the information is free from error, none of Westpac or its related entities warrants the accuracy, adequacy or completeness of the information, or otherwise endorses it in any way. Except where contrary to law, Westpac and its related entities intend by this notice to exclude liability for the information. The information is subject to change without notice and none of Westpac or its related entities is under any obligation to update the information or correct any inaccuracy which may become apparent at a later date. The information contained in this material and this website does not constitute an offer, a solicitation of an offer, or an inducement to subscribe for, purchase or sell any financial instrument or to enter a legally binding contract. Past performance is not a reliable indicator of future performance. The forecasts given in this material and this website are predictive in character. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The ultimate outcomes may differ substantially from these forecasts.

Transactions involving carbon give rise to substantial risk (including regulatory risk) and are not suitable for all investors. We recommend that you seek your own independent legal or financial advice before proceeding with any investment decision. This information has been prepared without taking account of your objectives, financial situation or needs. Statements setting out a concise description of the characteristics of carbon units, Australian carbon credit units and eligible international emissions units (respectively) are available at www.cleanenergyregulator.gov.au as mentioned in section 202 of the Clean Energy Act 2011, section 162 of the Carbon Credits (Carbon Farming Initiative) Act 2011 and section 61 of the Australian National Registry of Emissions Units Act 2011. You should consider each such statement in deciding whether to acquire, or to continue to hold, any carbon unit, Australian carbon credit unit or eligible international emissions unit.

Additional information if you are located outside of Australia

New Zealand: The current disclosure statement for the New Zealand division of Westpac Banking Corporation ABN 33 007 457 141 or Westpac New Zealand Limited can be obtained at the internet address www.westpac.co.nz. Westpac Institutional Bank products and services are provided by either Westpac Banking Corporation ABN 33 007 457 141 incorporated in Australia (New Zealand division) or Westpac New Zealand Limited. For further information please refer to the Product Disclosure Statement (available from your Relationship Manager) for any product for which a Product Disclosure Statement is required, or applicable customer agreement. Download the Westpac NZ QFE Group Financial Advisers Act 2008 Disclosure Statement at www.westpac.co.nz.

China, Hong Kong, Singapore and India: Westpac Singapore Branch holds a wholesale banking licence and is subject to supervision by the Monetary Authority of Singapore. Westpac Hong Kong Branch holds a banking license and is subject to supervision by the Hong Kong Monetary Authority. Westpac Hong Kong branch also holds a license issued by the Hong Kong Securities and Futures Commission (SFC) for Type 1 and Type 4 regulated activity.

Disclaimer continued overleaf.

Disclaimer continued

Westpac Shanghai and Beijing Branches hold banking licenses and are subject to supervision by the China Banking Regulatory Commission (CBRC). Westpac Mumbai Branch holds a banking license from Reserve Bank of India (RBI) and subject to regulation and supervision by the RBI.

U.K.: Westpac Banking Corporation is registered in England as a branch (branch number BR000106), and is authorised and regulated by the Australian Prudential Regulatory Authority in Australia. WBC is authorised in the United Kingdom by the Prudential Regulation Authority. WBC is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority in the United Kingdom. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request. Westpac Europe Limited is a company registered in England (number 05660023) and is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. This material and this website and any information contained therein is directed at a) persons who have professional experience in matters relating to investments falling within Article 19(1) of the Financial Services Act 2000 (Financial Promotion) Order 2005 or (b) high net worth entities, and other persons to whom it may otherwise be lawfully communicated, falling within Article 49(1) of the Order (all such persons together being referred to as “relevant persons”). The investments to which this material and this website relates are only available to and any invitation, offer or agreement to subscribe, purchase or otherwise acquire such investments will be engaged in only with, relevant persons. Any person who is not a relevant person should not act or rely upon this material and this website or any of its contents. In the same way, the information contained in this material and this website is intended for “eligible counterparties” and “professional clients” as defined by the rules of the Financial Services Authority and is not intended for “retail clients”. With this in mind, Westpac expressly prohibits you from passing on the information in this material and this website to any third party. In particular this material and this website, website content and, in each case, any copies thereof may not be taken, transmitted or distributed, directly or indirectly into any restricted jurisdiction.

U.S.: Westpac operates in the United States of America as a federally licensed branch, regulated by the Office of the Comptroller of the Currency. Westpac is also registered with the US Commodity Futures Trading Commission (“CFTC”) as a Swap Dealer, but is neither registered as, or affiliated with, a Futures Commission Merchant registered with the US CFTC. Westpac Capital Markets, LLC (“WCM”), a wholly-owned subsidiary of Westpac, is a broker-dealer registered under the U.S. Securities Exchange Act of 1934 (‘the Exchange Act’) and member of the Financial Industry Regulatory Authority (‘FINRA’). This communication is provided for distribution to U.S. institutional investors in reliance on the exemption from registration provided by Rule 15a-6 under the Exchange Act and is not subject to all of the independence and disclosure standards applicable to debt research reports prepared for retail investors in the United States. WCM is the U.S. distributor of this communication and accepts responsibility for the contents of this communication. If you would like to speak to someone regarding any security mentioned herein, please contact WCM on +1 212 389 1269. All disclaimers set out with respect to Westpac apply equally to WCM.

Investing in any non-U.S. securities or related financial instruments mentioned in this communication may present certain risks. The securities of non-U.S. issuers may not be registered with, or be subject to the regulations of, the SEC in the United States. Information on such non-U.S. securities or related financial instruments may be limited. Non-U.S. companies may not be subject to audit and reporting standards and regulatory requirements comparable to those in effect in the United States. The value of any investment or income from any securities or related derivative instruments denominated in a currency other than U.S. dollars is subject to exchange rate fluctuations that may have a positive or adverse effect on the value of or income from such securities or related derivative instruments.

The author of this communication is employed by Westpac and is not registered or qualified as a research analyst, representative, or associated person under the rules of FINRA, any other U.S. self-regulatory organisation, or the laws, rules or regulations of any State. Unless otherwise specifically stated, the views expressed herein are solely those of the author and may differ from the information, views or analysis expressed by Westpac and/or its affiliates.

For the purposes of Regulation AC only: Each analyst whose name appears in this report certifies that (1) the views expressed in this report accurately reflect the personal views of the analyst about any and all of the subject companies and their securities and (2) no part of the compensation of the analyst was, is, or will be, directly or indirectly related to the specific views or recommendations in this report.