5 September 2008

Westpac Institutional Bank

Long-life milk

2008/09 dairy payout forecast unchanged

- **Dairy product prices on world markets are well down from their peaks.**
- **The falling NZD will insulate returns to the farmgate.**
- **We retain our payout forecast of $7.10 per kilogram of milksolid for 2008/09 season, but reduce our forecast for 2009/10 to $6.00 from $6.30.**
- **A forecast 9% lift in production in 2008/09 will see dairy industry revenues just shy of the estimated $10bn in the previous season.**
- **Our five year average payout forecast remains unchanged.**

There is a divergence of views in dairy land. Those that are watching the NZD slide lower are getting hopeful that Fonterra will deliver a better than $7 per kg of milk solids payout in the 2008/09 season. Others, who are watching the fall in global dairy product prices, are suggesting that a $7 payout will not be achievable.

We'll place ourselves firmly in the middle because we are watching both factors! To be sure, Fonterra has set itself a challenging target for the coming season. In the interests of farmer retention, we think Fonterra's early estimate was a best guess at what they could achieve with less scope to increase the forecast as in previous seasons.

Increased dairy supplies (particularly from the US and EU including new member states) and rapidly reducing global economic growth has seen dairy commodity prices fall. Powders peaked first and fell the most and US milk futures indicate further weakness. Other dairy commodities like butter and cheese have held up better to date, but skim milk powder prices tends to lead the others and the direction is clear. Peak times and percent change from peak for the various products is shown below.

Product	Peak	% change from peak
SMP	July 2007	-38%
WMP	July 2007	-26%
Cheese	November 2007	-13%
Casein	January 2008	-15%
Butter	May 2008	-9%
Weighted average	November 2007	-21%.

However, as Asian economic growth in particular has finally succumbed to the developed economy slowdown, most commodity prices (hard and soft) have been falling. In tandem with NZ interest rate cuts in response to domestic recession, the NZD has tumbled.

The final dairy payout will be the result of a tango between commodity prices and the NZD. We expected a sharp pullback in product prices, to date the decline has been a touch faster than expected (average prices in August were what we expected for September). Our own estimates currently incorporate dairy commodity prices by season end being 50% down on their peak. That is another 36% fall from now. But the season average will only be 28% down on last season's average and we expect an average currency conversion of NZD0.69. This combination, with 35cents of value add, is consistent with a $7.10 payout. This remains our forecast for the current season. As things stand, we believe it is achievable but advise against farmers banking on significant overachievement on the early estimate.

We expect dairy volumes to be up around 9% in the coming season (due to the passing of drought impact, conversions, and increased intensity/productivity). Combined with a $7.10 payout, dairy farmer incomes (industry wide) for the coming season are expected to be just shy of the estimated $10bn from the previous season.

We have revised the 2009/10 payout lower on the softer outlook for product prices. We previously had $6.30/kgMS; our current estimate is $6.00. The full future track is given below.

	Payout
2008/09 (f)	$7.10
2009/10 (f)	$6.00
2010/11 (f)	$5.70
2011/12 (f)	$5.80
2012/13 (f)	$6.30
Average (f)	$6.17

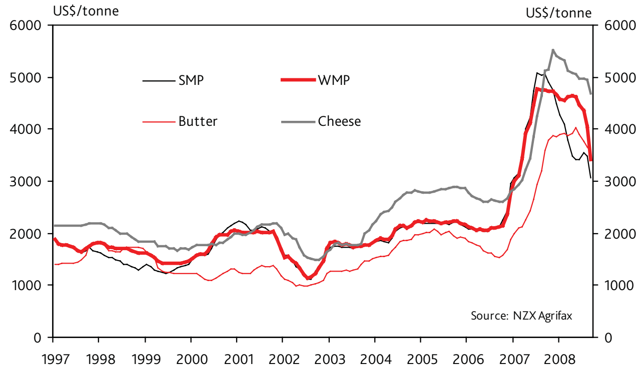
There is a lot of time between now and when these payouts are received providing plenty of room for shocks to come via exchange rates, commodity prices and other unforeseen events.

For further information, questions or comments contact Brendan O'Donovan, telephone (04) 470 8250, email bodonovan@westpac.co.nz

For the purposes of the forecast, we have assumed no changes from Fonterra's capital structure review.

One possible alternative scenario is for commodity prices to fall further than anticipated on weaker world growth and increasing supply. On the face of it, the 36% further fall in world product prices factored into our forecast is aggressive, but there is a risk that world prices fall further. However, in this case it is likely that the NZD would follow world prices down, thereby limiting the effect on the payout.

Dairy product prices



Brendan O'Donovan, Chief Economist, Ph: (64-4) 470 8250
Doug Steel, Senior Economist, Ph: (64-4) 470 8251