Company: **Synlait Milk Limited**

Conference Title: **Synlait Milk Limited FY17 Annual Results Investor Call**

Moderator: **Tracey Mitchell**

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Operator: Good day, everyone and welcome to the Synlait Milk Limited Investor Update Call. Today's call is being recorded. At this time, I would like to turn the conference over to Mr John Penno, Chief Executive Officer. Please go ahead, sir.

John Penno: Hi. Good afternoon, everybody. John Penno here and I've got Nigel and Casey with me in the room. So what I propose we do is just quickly talk through the announcements, what this means, and then turn it over for questions. And I do acknowledge that a lot of you were probably in the room with us in Auckland a little more than a week ago, where we talked about the business, gave you a thorough update. We looked at the – and performing of packaging line. We've reached[?] [inaudible]. And we alluded to where we might be going next in terms of category. So we would like to thank [inaudible]. It would have been nice if we had this talk about then and perhaps would even design things as such. But sometimes, these things just take a little longer than you expect to get over the line. So let's fill in those blanks today.

So we see ourselves as a dairy manufacturing business that's working across the supply chain in partnership with key customers who had great distribution, great brand and can help us move our products to the right consumers. We've got great milk supply, good raw material procurement. We're increasingly investing in research and development. We have learned over the last decade about manufacturing excellence and have more to learn in that space, but I'm proud of the quality of products that we already manufacture.

And we've been embarking on strategy for sometime of getting as much of our products as possible into consumer packs. So that is the most advanced in our portfolio[?] of business, where we work closely with what we call a business-to-business-to-consumer customers, our B2B2C customers where we are making the consumer packs in their brands for them to distribute. Of course, what we're doing in quality and laboratory is an important [inaudible], making sure that there is regulatory access for our customers to markets[?].

We've started to talk about the categories that we want to move into and the importance to us of being able to diversify markets and geographies; the importance of continuing to deliver and stream as much of our milk as possible into the highest returning products. Being – you know, acknowledging the changing world, [inaudible] not only today but that is going to occur in the future through the life of the plants and the processes that we work with. Focusing on B2B but moving closer and closer to our customers and to consumers. And, of course, beating[?] supply chain integrity across everything we do. We've been in ingredients[?] for some time and that will remain an important business to us. We have a well-established infant formula business now, both in terms of blending or making ingredient products for the world's infant formula industry, making our own finished infant formula products. We've [Inaudible] invest and more [inaudible] with mix capability to get full utilisation of our spray dryers and more consumer-packaging technology.

We've also started talking about an ambition to move into [inaudible] formula and the announcement of the plant that we'll manufacture or that we'll build today on site here in Dunsandel, is the plant that will bring capability to move unto those [inaudible] infant formula products in time.

We've also started to talk about everyday dairy. And everyday dairy, as simple as it sounds, it's the fresh dairy products that we consume in our homes every day. Not only do we consume them in our homes, but we increasingly consume them when we eat out with our families and friends. It's the milk that we have in our flat whites[?] and the cafes and in our workplaces.

And on top of that is cream opportunities. There is a lot this fresh cream opportunities in New Zealand, but more importantly growing cream opportunities for food service type arrangements, or food service type of vocation, I should say, in export markets.

And then in adult nutrition, again, we see opportunity for ready-to-drink blended dairy beverages that leverage off the things that we've learned in terms of control and quality. And blending ingredients with milk to manufacture products that are really good for people, fit-for-purpose and mean that our consumers are healthier because of the products that they might consume.

So today, what we're really announcing is that this is a strategic diversification. We see this is continuing to help us transition away from commodity products into high-value products, and that is our core strategy.

We've done a lot of research in this. And we're comfortable with this fresh dairy product category. If manufactured in the right way on a modern plant, at scale can be high returning. Not as profitable as our formula products, but certainly significantly a bit of the ingredient products that we'll be moving away from.

And we think that the New Zealand market is ripe for innovation. It's been a long time since new technology has been built into the New Zealand market. And this gives us the opportunity to build a plant that not only enables our ambitions and blended export long-life products to be realised, but also to get a very high-quality fresh milk into the hands of New Zealand consumers, from the farmers where we're so proud of the way that they produce the milk, and how they're managing their animals, their land and working with their people.

So too underpin the strategy, we've negotiated a contract with Foodstuffs South Island. And from early 2019, we'll be becoming their exclusive manufacturer of all of their product[?] labelled milk, which we see it as first step into this new category. It's a ten-year contract and that underpins our ability to invest – make a large investment here at Dunsandel, which opens up the opportunity to make into these ready-to-drink products and export long-life products.

In terms of milk supply, as most of you will know, we do have enough milk. We don't really like talking about it as surplus milk. It's not surplus milk, it's very high-quality milk that, at the moment we're exporting because we don't have manufacturing capacity for it yet. But this is going to be a great use for that milk and we're very pleased to be making it available to New Zealand consumers.

So, a few details on Foodstuffs South Island contract, it's exclusive supply. You'll see it turning up from their value [inaudible] brand[?] from the early 2019. It's their retail contract – it will be retail channels at the South Island on the PAK'nSAVE network, New World, Four Square and On The Spot stores. And we like the length of the contract. It gives us certain confidence to invest with that sitting underneath with that capital investment.

It's the large investment. And for those who start doing their work, you'll see that this is a much bigger investment that would need to simply manufacture pasteurised milk for the local market. That's not what this is about. This is about doing that, underpinning the investment, but having – opening up a whole range of new options for us to grow into in the business.

The investment that will be funded through retained earnings and debt facilities. Has an annual capacity of about 110 million litres a year. And of that, about a third of that will be required to – with our partnership with Foodstuffs to – for the supply of fresh milk and cream through their brands. But as of [inaudible], it's capable of manufacturing a range of new and exciting export products as well as those traditional products.

The development seems to – the new product development seemed to – in Palmerston North with Massey[?] University is actually the – a big part of the reason we went there was to make sure that we had the team and access to [inaudible] developing the sorts of products that we see ourselves moving to, and being ready technically the movement of this new space as we turn on the plant.

Look, I would draw your attention to the long-life cream export category. We mentioned that at the Investor Day and talked about it at some length0. We see this as a very important growing category, something that we'll be able to do particularly well with these plants and bring significant product difference to the market in terms of the packaging that we'll be able to put all those products into.

So we don't see this as a change in strategy. This builds on [inaudible] our current strengths. And if you look at the diagram on the last page, the thing that's changing is that the consumer packaging options that we're putting in place for streaming our products, that too is growing. We've got well-established in the traditional canned product for infant formula. We've talked about the importance of blending and sacheting for not only for formula products but also adult and family powdered products. And now, we're saying that we are moving into the consumer packaging of liquid products, both for pasteurised milk for the local market. And potentially more important long-term, blended, long-life dairy beverages for the export market and blended cream products for the export market.

And so with that, I'll turn it over for any questions that might be here.

Operator: If you would like to ask a question, please press star followed by the number one on your telephone keypad. If you're calling from a speakerphone, please make sure your mute function is off to ensure your signal can reach our equipment. Again, star one to ask a question.

We'll go first to Luke Mills from Craigs Investment Partners. Your line is open.

Luke Mills: Cool. Good afternoon, Tim[?]. I've just got one quick question around what you expect the earnings contribution to be from the plant, I guess in the short term, as a plant has a more fresh milk/cream focus portfolio, and longer term as you shift your product mix into more value-add categories.

John Penno: Yeah, look, John Penno here. We won't give specific earnings on the different categories. What we'll say is that we're completely comfortable with the rate of return that we'll achieve on the plant. I guess our base case is based around the local liquid milk market and building into the edible[?] cream market, which is a very fast growing market out of New Zealand and bring it – it has terrific advantages coming from New Zealand in the coming short, you know, medium term. Our hurdle[?] rate has always been about 20% and you wouldn't expect to see a – use a different number at this point.

Luke Mills: Okay, cool. Thanks, guys.

Operator: Again, star one if you'd like to ask a question. We'll go next to Arie Dekker from First New Zealand Capital. Your line is open.

Arie Dekker: Good afternoon, guys. Just a few questions from me.

Firstly, in terms of the investment you've talked about of the $125 million for the platform, and I appreciate your comments about that giving your capability well beyond pasteurised milk. Can you just sort of outline – I think you mentioned in the release four or five different opportunities that this platform opens up for you. Will further follow-on investments be required on the $125 million too to open up those opportunities or does that cover all of the ones you've identified?

John Penno: No. The options we've identified, they are all capable of being manufactured out of the plant that we're building in first instance. So no, there's no further capital requirement. Now, the only proviso that we put on that is we do acknowledge we have a lot to learn in this space. We've done a quite – as you might imagine, we have done a lot of work already in terms of making sure that we understand the products, how they're made. And while it's a new technology for us, that's not new for the engineering firms who have built these plants. There has been a lot of advance around the world. You know, we've got Roger Schwarzenbach here. We've had him onboard for the best part of calendar 2017 and he's one of the world's experts in some of these products. That's a big part of the reason we brought him into the team.

He's been bringing in other technical people who, located both here and up north[?}. So we were reasonably confident in the investment and its capability and its ability to extend into the products that we have named. That said, the business case from our point of view has been premised on the partnership with Foodstuffs and growing into the cream products, which we see is the, I guess, the low hanging fruit, the easiest to achieve. We haven't built any of those more technically difficult products into our business case, but we see that as options that we are opening up by investing in this plant.

The one area that where you will – and we've been signalling this. We see an increased investment going into R&D in the coming years. That's, you know, we've talked about being in about 4.5% of revenue and we do think we need to be at the level. So the investment won't be so much in plant and equipment, it will be into developing the technology and the risk piece and the products that we [inaudible], and the team to run out of these plants.

Arie Dekker: And potentially, if you move into some of the R&D stuff, then potentially some additional investment required to that as well, outside of R&D?

John Penno: No. We're confident there to manufacture the products that we have named. We won't require additional capital. It's a very, very sophisticated piece of equipment[?] that we're putting in. It's – I mean, you could argue it's wasted on pasteurised local milk. But the fact is that if you build – there are real economies of scale, the manufacturing, that come from building very large plant. [Inaudible] when you saw us going into infant formula, we built the biggest infant formula plants in the world at that time. We've taken a similar approach here. We've researched it well, we're confident of the market, we're confident of the volumes that will come, and that means that we've been able to build a very scale, high-capability plant that creates a lot of options for us going forward.

Arie Dekker: That's cool. And is there any additional warehousing that has to built into this investment that you've outlined? And if not, is it a message that more warehousing will be needed to add, to grow into that 110 million litres for this product?

John Penno: So there is, as part of, contained within that $125 million, there is a significant investment in cold storage. Because, of course, as we move into pasteurised products, we need to keep them cool. Once they're manufactured, they can't be stored at ambient. And in fact, some of the more sophisticated long-life products will still be – will be controlled in – [inaudible] to control the temperature environments as well just. So all of that has covered in the capital expenditure, the number that we've quoted the [inaudible].

Arie Dekker: Great. So the warehousing will [inaudible] is included?

John Penno: Correct. All the requirements for this project are contained in there. There's also some sophisticated product handling technology at the backend of it as well. We're not dealing with 25kg bags or cans of products. So there's a lot of automation on the backend for it because we are moving into a retail environment here, where –as hand over products to Foodstuffs. We're working to innovate right across the supply chain and remove cost wherever we can.

Nigel Greenwood: Arie, Nigel here. Just confirming that this project is not dependent at all on our ability[?] to have a dry store. This project will likely use part of our existing dry store for raw material and packaging requirements. The [inaudible] whether we need to expand the dry store requirements on this site is a separate process. And we've talked about that historically that we're not yet committed to creating[?] another dry store on this site at all but it is certainly something that's under review. And that's all I think as far as we can go on that [inaudible].

John Penno: Yeah. Look, you wouldn't –

Arie Dekker: Yeah, that might [inaudible].

John Penno: I mean – what I mean was… Carry on, Arie.

Arie Dekker: All right. Just to Nigel's point there that might more tie in was creating the base IS[?] or the finished IS, that separate warehousing consideration.

John Penno: That's – the warehousing requirement of this project will be much – it won't be very great. The big increase in requirement for storage is finished product and cold storage, and that's all contained within the scope of the project.

Arie Dekker: All right, two more quick ones. Just to [inaudible] obviously, the [inaudible] of liquid milk in New Zealand has been obviously pretty concentrated. Foodstuffs, are they looking at this as an opportunity to reduce the price points in the category in their private label?

John Penno: We can't – obviously, the retail [inaudible] is partnership. So we won't be talking about what might happen in price. But when you build a large scale plant and rethink the supply chain, it's fair to say that there's opportunity to make savings, we believe that we are as part of this. But in terms of what might happen in pricing, that will play out through Foodstuffs' choices.

Arie Dekker: Sure. And then you might be able to just help me quickly. Just on the tariffs that you've talked about in relation to the export cream and that coming down, and I know you did mention that at the Investor Day, are there any – are those tariffs that also come, add any volume restriction in that particular category, for New Zealand as a whole?

John Penno: Look, there is some complexity in there and some of that is being talked about right at the moment, particularly with that key note[?] in China. There is an advantage for us at the moment, [inaudible] that's going to increase at time, I think it's 2022 is the period. You know, how that might play out in terms of volume restrictions, and so forth, time will tell. But we're not building it for those tariffs. We just see that as another driver to continue the growth the New Zealand is enjoying in that category at the moment. And we think that that's something that we can do well, and we certainly have some ideas about how we'll be differentiating our products from others in the market, right at this time.

Arie Dekker: Thanks, guys.

Operator: And again, if you have a question, please press star one. We'll go to – I'm sorry – we'll go to Nick Mar[?] from Macquarie. Nick Mar from Macquarie, your line is open.

Nick Mar: Hey, guys, just one from me. How does this look in terms of your plant[?] utilisation, through the milk curve? Obviously, fresh milk and NUHT[?] is a bit flatter – sorry, long-life cream's a bit flatter in terms of the curve. So how are you going to manage that, in terms of dry utilisation?

John Penno: Yeah, look, that's a good question, Nick. It is a, you know, the off take from that line, will be constant, more or less constant. Certainly for the domestic market, it will be constant, and then we'll see growth in the product streams, but it will be de-linked from the New Zealand milk supply curve.

We certainly see that in our formula business, now that the off take is completely consumer and market driven, it's – and growth. And the relationships with our customers doesn't have anything to do with the, I guess, the push. That's always been how we thought about our business, so we think about it as growing value with our – for consumers, and partnership with our customers. And then we manage everything else.

So we'll need to take on a little more winter[?] milk, we already have some winter milk. But actually it doesn't impact the dryers, because you're taking a sort of a slug of milk out right through the year, constant volume, if you like, month by month. So it does not – it doesn't improve things for the dryers, other than to take some load, you know – at times when we have to process milk, it can take some of it away. But it certainly doesn't make seasonality any worse for us either.

So we see it as neutral when it comes to that. It's not offering advantages, but we don't see any particular disadvantages in it either.

Nick Mar: So, [inaudible], this is starting to address some of that big capacity issue that you're facing at the moment, or is this something that's sort of separate?

John Penno: We see it as a little separate. This is the line where we could, if you like, really crank it up and take the peak out of the season and store other product for – once we're in the long-life type products. Sometimes, dairy companies will do that sort of thing. We haven't worked that into our modelling, and we are not necessarily looking to work with our farmers to move their seasonality either. This will still be quite a small part of that overall milk volumes, even when it's [inaudible] 110 million litres, that's you know, less than 20% of our total volume.

So again, we don't see it improving seasonality, but we don't see any particular disadvantages and seasonality either.

Nick Mar: Thanks, guys.

Operator: And again, it's star one if you'd like to ask a question.

John Penno: I think we are going to need to wrap it up.

Speaker: Yeah.

John Penno: So look, thanks, everyone for participating, and I'm sure, you know, we acknowledged this is day one, and it's on Christmas eve. So we look forward to having more discussion with each of you over time, as we can talk more about this, and as you sort of start to understand what this might mean for the future of the business. We are certainly very excited about it. So thanks for participating.

Operator: And that concludes our call for today. Thank you for your participation. You may now disconnect.