Company: **Synlait Milk Limited IML**

Conference Title: **Synlait HY Results Call 2019**

Moderator: **Clayton Cleek**

Date: **Wednesday, 20th March 2019**

Conference Time: **10:00 (UTC+12:00) Auckland, Wellington**

Leon Clement: My name is Leon Clement. I'm the Chief Executive for Synlait Milk Limited. And it's my pleasure to welcome you to the interim results overview that we'll provide this morning. Sitting next to me is Nigel Greenwood, our CFO. He'll take you through some more detail of the financial results later on in the presentation.

Before we start this morning, I think it's important that we just reflect on the events that impacted our community in Christchurch last week. Synlait employees have – are all indelibly impacted by what occurred, we're shocked and saddened by those events. And I'd just like to take the opportunity to thank many of the people on the call, many of our customers and suppliers and partners from around the world that have sent us their messages of support and concern as part of this event.

So, this morning we'll step through our result. We've just posted that on the NZX. I'll provide an update strategically on where we're going and part of the progress that we're making against our strategy. And Nigel will talk more formally to our results.

This morning we're announcing a net half year profit of $37.3 million for the half year, ended in January this year. That's 10% down on the same period last year but 12% up on the second half of 2018. We're reconfirming our guidance for the end of year for 41,000 to 45,000 tons of infant formula volumes, and again, reconfirming the guidance that profitability will increase in F19 but not at the same rate as it did in F17 to '18.

Overall, this is a really solid result for the business. It reflects strong manufacturing efficiencies that we've driven through the organization and it shows that we've been able to sustain our overall gross profit margins, at the same time as investing in both future capacity, capability and our organization to grow for the future. And I'll allow Nigel to talk to that in a little more detail to give you some context for why we believe it's a strong result.

At the same time, I'm really proud of the efforts across the business. Our main projects – we're doing a lot of building in both our Auckland advanced liquid facility and our Dunsandel and our new Pokena site up in the North Island, both of those large capital projects are on track and they're very complex projects and I'm really impressed with the way this organization is able to deliver those projects on track and to budget.

We also continue to explore new exciting growth opportunities in the organization, as well as our investments in liquid milk, we see strong opportunities with both customers and new categories in those spaces. And we look forward to assuming ownership of the assets of Talbot Forest Cheese, which remains a very complementary asset for our business both in terms of growth opportunities and optimizing our value chain. We're also very excited about the doubling of our lactoferrin capacity. This high-value specialized ingredient has great potential for us and we're building some strong capability in that space.

As I mentioned before, we've – this result reflects some very strong improvements in manufacturing efficiencies, that's allowed us to process more milk and is a strong part of our result today.

We also launched our new purpose just before the end of last calendar year. It's Doing Milk Differently for a Healthier World. It's really driving the organization forward as we start to clarify and focus our purpose, ambition and strategy. And I'll give you a bit more clarity on that as we go forward.

At the end of last year – financial year, I spoke about what our objectives were and what we needed to achieve as an organization and what our challenges were going forward. We talked about two important parts of our organization; continuing to grow and diversify both our customer and our category base so that we'll build a strong, stable, diversified organization. But at the same time, we needed to invest in our capabilities going forward, so that we strengthen the organization and enable our organization to grow.

Just a quick update on some of the key achievements against those two portfolios that we've had in the past six months. I'm really proud and impressed with the team's ability to continue to build agile and responsiveness into our supply chain and meet the demands of our key customers including a2. Those strategic partners are really important to us but we continue to work tirelessly to deliver to their needs and respond as best we can there.

We've made major investments in the Everyday Dairy category with the establishment of our advanced liquid dairy packaging facility at Dunsandel with Talbot Forest Cheese coming online and our lactoferrin capacity, as I mentioned before, we see exciting opportunities there.

On the capabilities side, really good investment and new exciting opportunities as our team invest in R&D and invest in the key customer and consumer opportunities we see around the world that complement our assets. We're excited about that. You'll also see in our result we've processed 12.4% more milk this year and that reflects significant manufacturing efficiencies that have been delivered over the last half.

Our Lead with Pride program continues to expand with over 60 suppliers now certified as Lead with Pride, and we continue to make progress on our sustainability commitments that we announced last year.

We've been working hard across the senior leadership team and with our Board to clarify our purpose, ambition and strategy. We use a construct called heart, head and hands, where the heart represents our purpose, our why; the head is our ambition and what we're trying to achieve and our aspirations for growth; and the hands is our strategy where we take action against both of those to create value for our shareholders.

Our new purpose is Doing Milk Differently for a Healthier World. We think this captures the essence of the organization and why we exist. And there's three big ideas in there. Being different and doing milk differently is part of Synlait's DNA. We've always been a disruptive organization. We've been open to new ideas and innovation and it's a core part of what we do. We apply Doing Milk Differently across our business, not just because we want to do things differently but because we believe that in exploring different ways of doing things, we'll ultimately find better solutions for our customers.

The new purpose also expects – reflects our core business of being an essential nutrition and the health and wellness that we're bringing to customers and consumers around the world, and for our ability to invest in a healthier world for people and planet and allowing all to thrive.

There's a lot of work that's gone into clarifying on our ambition. Our ambition has a cascade of a clear set of goals for the organization which we're about to launch. And I'll just reflect and provide this quote on how we feel about our ambition once we look back on it. I think the organization will feel proud of the stance that we've taken, the global difference we've made and the sustainable and diversified company that we've built together.

On the right-hand side of the current slide, we've got our strategy. And again, we've been doing some work to commit, purpose and strategy together here. Doing Milk Differently is the portfolio of work that reflects our categories and we have key programs of work that are driving activity across infant nutrition, everyday dairy and ingredients and adult nutrition.

The For a Healthier World is the activity that enables our growth strategy and helps us drive value into our sustainable value chain. We believe we participate in three very chains and environmental one where we give and take resources from the planet; our people value chain, where we bring leaders in and participate with communities and stakeholders around us; and our enterprise value chain, where we take milk from our farmers and convert it into high-value nutrition. This program of work reflects what we're doing across the organization to enable growth and build capabilities to support our growth plan.

What I'll do now is step you through a brief update. I'll dance through this quite quickly. There's a lot of detail on this deck and you can refer to it on our website later on. But I'll step through some of the key activity across each of the seven circles in our strategy.

Firstly, infant nutrition, really important category for us and a part of our historical success story. The topline message here is that our strong partnership with a2 continues to grow. The other brands that we are seeking to build a diversified portfolio with were expected to achieve regulatory approval in China and continue to move that forward with United – with the US ambitions, and they are taking longer than expected. So, we continue to move through those processes accordingly.

We continue to invest in future capacity for future growth. That's reflected in our investments in the new Pokeno site. And we'd like to reconfirm our outlook for 41,000 to 45,000 metric tons this year for infant canned volume guidance.

Just want to update the market that our Pokeno site remains on track. We're excited about bringing that site to life. It brings us away from a single site reliance we have down here at Dunsandel and gives us geographical diversification. We hope to have that plant up and running and approved in early financial year F20. And again, we'll start that plant up with a product mix of ingredients and base powders, which allowed us to get moving and test all of our systems before we move into more sets of infant nutrition.

We're also really pleased with the progress we're making in milk supply development. Our recruitment of farmers is going well and we're really pleased with the welcome that we've had from kind of farmers to our presence in that area.

A little bit on our partnership with the a2 milk nutrition company. I think I mentioned before that there's been a lot of effort this half and making sure we meet the demands with the a2 Milk Company. We announced last year that we've reconfirmed the minimum supply agreement four or five years in July 2018 for our partnership and exclusive supply arrangement for Australia, New Zealand and China products for the a2 Milk Company.

We continue to work really closely together with a2 as an important end customer and an investor in our organization and we're very proud of the strategic partnership that we have together. And look, this is just a great story to be part of. Many of you will have an interest in this organization if you have an interest in Synlait. And I think the results that they continue to deliver and exceed, if not, meet the expectations of the market are strong and continue to give us confidence that we'll have a strong future together.

I want to give an update on the regulatory status of our core infant nutrition portfolio. We continue to push for building a diversified portfolio with differentiated milk with a2 and Grass Fed program with Munchkin and build a strong domestic portfolio.

I'll give two updates here, one on the status of our sites and then on the status of our brands. Our Dunsandel site received renewal of GACC registration formally the CFDA – or sorry, the CNCA, for our Dunsandel site. We received that late last year. That allows us to continue to export infant nutrition to China. Our Auckland plant is going through that process. We're progressing well through that process and we expect registration for that later in the year. We currently have GACC Dairy Certification and we're working through the process for infant nutrition.

In terms of Pure Canterbury and Akara range, we are in the process of registration for those brands. We have seen movement in the China regulatory framework for that and that is a good sign. It's positive to see that the COGS are starting to turn again. We're receiving questions and providing answers. And we expected that our Pure Canterbury brand with Bright will be approved later in 2019 and the same for Akara, with e-Akara perhaps later in 2020.

For our Munchkin brand, we're resubmitting out US FDA approval for stage one. Our focus now moves to growing sales with Australia, New Zealand, and for stage two for US sales. So, we're working very closely with customers on moving those forward.

Moving now to Everyday Dairy. We're very happy with the progress, as I said, on our advanced liquid dairy processing facility. We also have Talbot Forest on track and that organization continues to make the expectations we have to satisfy the conditions we have in assuming those assets. That allows us to, I think, both participate in a very relevant adjacent category to the fresh milk that we're entering with Everyday Dairy. But more importantly, it allows us to optimize our asset base. It gives us a place to put fat, which we have excess of, with our strong indexing of infant, which has a skim profile; and also allows us to optimize and manage the peak flows of milk that come into our plant for seasonal variations in the New Zealand milk season.

So, Talbot Forest is both a very strong acquisition in terms of allowing us new – access to new growth opportunities but also to optimize our supply chain. We're also focused heavily on building new opportunities out of the facility that we are building at Dunsandel. UHT cream, ambient drinking yogurts, functional beverages and we're also exploring ready-to-feed infant nutrition to be produced out of that factory and our product development streams and our customers – our conversations with customers are going very well on that space.

I'll move now to ingredients. It would be remiss of us not to reflect on the impact that our ingredients portfolios had on our result this half. As I mentioned, we've processed 12.5% more milk this season. That reflects some really important efficiency improvements that our team has been working on. And frankly, our ability to therefore produce an increased ingredients production by 21% this year supports the underlying profitability in our business. And behind that is a metric that we measure called overall equipment effectiveness. We've seen a 6% improvement on that. And for any of you that know that metric, you'll you realize that that's a really strong improvement. It basically allows us to get much more out of the stainless steel that we own and it's a very strong and important part of our overall portfolio.

Likewise, lactoferrin, we've doubled capacity in lactoferrin and we're very excited about the potential for this category for us. We feel we are building very strong confidence in the ability to design and build and to run these plants and we're able to produce a very high grade and very high spec lactoferrin. This is a high-value, very sought-after nutritional ingredient. And our conversations with existing and new customers around the world are encouraging. As the chart shows below there, we expect to produce 20 metric ton of lactoferrin in the second half and that will contribute to our future result.

Moving now to the second part of our strategy around environment, people and enterprise. Making good progress on our commitments for greenhouse gas reduction. We're doing that in twofold areas. The first one is on piloting a methane inhibitor that we've been working on. We're excited about that and look to be piloting that in late 2019. And in decarbonizing our own manufacturing footprint with the introduction of an electrode boiler rather than coal on our Dunsandel site.

We're also looking to minimize water use and water degradation. That has a two-pronged approach again, both looking at working with our Lead with Pride family to reduce on-farm water use and water degradation with our Lead with Pride framework and working on emerging technology to improve wastewater quality out of our factories.

Similarly looking to work on pioneering the circular economy for plastics in New Zealand and eliminate single-use plastics and working on standing up a range of activity to lead stewardship for animals, biodiversity and soil. So, a lot of activity going into our environmental pillars and an important part of our program.

Likewise, our people efforts are very strong. Our injury frequency rates continue to drop with a 13% improvement there. I should underline we're not where we want to be there and we continue to focus on critical risks, injury management and we have launched a wellness program there this year to complement our efforts in that space.

Our engagement continues to improve and we've launched a diversity policy this year that's focused on our leaders accelerating development of underrepresented groups, focusing on building a strong culture and introducing a flexible way of working for our staff to balance busy lives.

And the enterprise work around our portfolio. We talked about earlier in the year about becoming the first B Corp for ANZ listed B Corp in New Zealand. We're on track to be certified by 30th June. We're committed to building science-based targets, which means the climate targets that we build reflect, on an international stage, the contribution to keeping global warming at or below 2 degrees. We have progressed with building our climate change impact and reported that through to CDP and we're working through ESG risk rating reports and looking on improving those metrics as well.

Lots of strong effort across the business to focus on food, safety and quality. Our GACC registration for Dunsandel was evidence of that. But we are focused also on improving our quality systems and processes and working across the organization to lift our performance and continue to make that a point of difference for our customers. Our innovation investment remains strong, as does our investment in building sustainable supply relationships across our farmer base and key supplies around the world.

So, I'll pause there on talking through strategy. That's the strategic update. As I'm sure, you can tell there's a lot of activity across there. This is a really exciting business. All of our people are making a strong contribution to it and we're really excited about the future as we move forward.

I'll hand over to Nigel now. He'll take you through the financials. And then I'll come back for a confirmation of outlook. Thank you. Nigel.

Nigel Greenwood: Thanks Leon. Welcome to you all. I'll start out with just a brief overview of the financial result. I know that Leon has given a high level here but the key messages are – I don't know that we will repeat this probably a few times this morning – that we believe our $37.3 million NPAT is a very solid result. We've achieved that predominantly on the back of sustained infant sales at a similar level to the first half last year, but more importantly, through increased ingredient sales. And that has only been achieved through our ability to be able to process more milk through our existing manufacturing equipment than we did in the first half last year.

So, you'll see that we've actually had a 26% increase in the amount of powders and cream sales half-on-half. Whilst we have had a small increase about 5% on our infant sales half-on-half, these were at lower margins. We signaled that about six to eight months ago that we would be likely to be having lower margins going forward there as we extended our key contract for an extended period of time, and that is playing out in our result now.

The other key change that we've had when we compare our result to the first half of last year is that we've seen our SG&A costs, or our overhead costs, increase about $5 million half-on-half and that is predominantly as a result of our continued focus and emphasis on growing the business. You will see that we've increased the number of people we have in the business and increasing our expenditure in areas such as consultancy in order to ensure that we are laying the groundwork for our future growth.

The 26% improvement in ingredient sales is a material amount, and we've talked about the manufacturing efficiencies that we've achieved and they – and we've talked historically, I think, probably for about two years now about the introduction of our IWS program in order to achieve that. And that is really now playing out in our result.

Whilst our infant sales volumes are roughly a little higher than first half last year, we do expect to have significantly higher infant sales in the second half. You will have to work that out from the range that we've given for full year guidance of between 41,000 and 45,000 and the fact that we've done about 17,500 tons in the first half, it doesn't – you can figure out that we will have a much higher level of infant sales in the second half and a much higher proportion of infant to ingredient powders and cream sales.

The consequence of the increased milk process has also not only increased sales but also increased finished goods and inventory. That will play out in terms of the sales out of that in the second half and we've also seen our raw materials inventory levels increase by the end of the first half as well, and that's predominantly to enable us to be able to increase our manufacture of infant products in the second half.

We introduced and commissioned our second lactoferrin plant in November, and so as a result of that we are seeing increased lactoferrin production occurring now. In respect of production volume, overall, we manufactured 90,000 tons of products in the first half. That's a 10.5%

increase on the amount of product we manufactured in the first half of FY18 and it's primarily – the increase is primarily in powders and cream. And you could see that the product mix is therefore also moved from 78% to 81% in respect to powders and cream versus infant manufacture.

A key metric that we've always focused on is our gross profit per metric ton. And you'll see that the gross profit per metric ton has dropped in the first half of FY18 from both the first – or second half and the first half of FY18. And the reason for that is a mixture of two things. One is the change in product mix as a consequence of selling more powders and cream, which is a lower returning product than our infant product. It does reduce the margin per ton. The other reason is the fact that we've already talked about our lower margins that we're receiving on our infant product.

Having said that, you should expect that the margin per ton will significantly increase in the second half of this financial year. And the reasons for that that we will sell much higher proportion of infant to total volume of products sold in FY19 in the second half. So, that's something to look forward to.

The other contributor I should just note there is our lactoferrin sales. You'll recall from the page earlier in the presentation that we expect to manufacture about 20 ton of lactoferrin in the second half. Most of that will be sold through and we are getting very good returns on our lactoferrin business at the moment and that will also assist our margin per ton performance in the second half.

Overheads. I've already talked to the fact that we have had an increase in our overheads half-on-half compared to FY18. But it's worth noting that when you look at the second half spend of FY18 of $29.7 million in overheads, our first half spend of $29.2 million is roughly in line with that. So, you're not seeing a material movement half-on-half to the second half of last year, but we are still continuing to increase and you should expect that our overhead expenditure in the second half of FY19 will increase on the first half.

Operating cash flow. After an area[?] of some complexity in terms of how that plays out within our business, I think the key issue to note here is that when you look at the graph on the page, we'll see that historically back in FY16 and FY17, we've had very little in the way of operating cash flow in the first half and significant operating cash flow in the second half.

Last financial year that sort of played out on the opposite direction and there were a number of anomalies that caused that in last year's results. But the signal that I'm giving you today is that whist we have had a solid first half of operating cash flow, you should expect that our second half operating cash flow will be significantly higher than what we've achieved in the first half. The reasons for that will be; one, the sell-down of all the finished goods inventory that we haven't stock at the end of January that will be sold through and through the second half, and the other reason, of course, is the increased level of infant formula sales that we'll have in the second half also been turned into cash, which is a positive outcome.

And lastly, net debt, a key metric for the business as well. I remember sitting here one year ago at the interim results talking about our net debt at $49 million and saying that that was laying the framework or the foundation to enable us to enter into a very strong period of capital expenditure over the next 12 to 24 months. And we're now seeing that play out. We have spent $250 million in capital expenditure over the last 12 months. $200 million of that has occurred in the last six months. And you'll note that the key areas are obviously liquid – advanced liquid milk plant, the lactoferrin plant, and of course, the build of our Pokeno site.

So, that is therefore translated into an increase in total net debt to $287 million by the end of January. Now we are being able to fund that and we'll continue to be able to fund that out of our operating cash flows and our bank facilities and also remain within the comfort levels of our leverage ratios that we have committed to within the business.

So, as a result, we do not expect that there'll be any immediate need to raise capital to meet our existing commitments. And in addition, we are continuing to signal to the market that we have no immediate intent to pay a dividend.

And on that note, I'll finish my presentation and hand back to Leon.

Leon Clement: Great. Thank you, Nigel. Just a little close out comment from me before we open the floor for questions, and not too much new news here but there's a slide there on what our outlook looks like. I think what Nigel summarized and I think the key messages for us this time is that we're continuing to drive strong profitable growth into the organization, and importantly, our overall business performance continues to improve.

We're signaling that we're returning to the now more typical seasonal profile in our organization with a softer first half and a stronger second half. And what's important is that whilst we continue to maintain growth, we're also able to fund and execute against delivering and preparing ourselves for future growth in terms of increasing capacity and capability across our manufacturing base.

So, overall, a positive outlook for the organization. As you can see from the chart, it will be a busy second half for us. Our guidance range remains 41,000 to 45,000 metric ton of infant. And I would just like to signal that we'd really like to welcome investors here in early June just to step through our new facility that we have here and we'll provide some more details for you in the coming weeks around that event.

So, on that note, we'll finish off stepping through the presentation and we'll open the floor for questions.

Operator: And at this time on the phone, if you do have a question, that will be star one. Again, that's star one for questions. We'll hear first from Sam Teeger with Citi.

Sam Teeger: Hi. Good morning, everyone. Just want to talk about lactoferrin. Just keen to see what you're seeing to stock prices for lactoferrin? And also, given what you're seeing in the moment and also some new supply coming online, where do you see lactoferrin prices hitting over the medium term?

Leon Clement: Look, we're adjusting sound levels in the room that we're in. I'm just wondering if you can repeat the question. I understand it's around lactoferrin and how demand is coming online?

Nigel Greenwood: Yeah, if you just talk up about, that will be helpful.

Sam Teeger: Yes. Is that clearer, Nigel?

Leon Clement: Yes, that's better. Thank you.

Sam Teeger: Great. Yeah, sorry, just wanting to ask about lactoferrin in terms of what are you seeing to spot prices at the moment and also given what you're seeing from demand from your [inaudible] supply coming online, where do you see prices heading over the medium-term?

Nigel Greenwood: Well, I think the market is well aware that we've seen spot prices of lactoferrin move materially up over the last 12 to 18 months. Only two years ago I think that was sitting in somewhere around US $200,000 to $250,000 a ton. We've moved through that period. And today they can't – I mean, there were some – for China spec lactoferrin, which is a specialized lactoferrin, it can be as high as US $1.2 million per ton. So, they are materially higher.

I should remind you though that the lactoferrin that we manufacture and sell, about half of it is already committed to a specific customer, whilst the other half is used for a combination of spot sales as well as internal use. We would expect to use about 2 ton to 2.5 tons of lactoferrin internally this year, so the balance will be sold externally.

And in terms of where I see prices going in the future, I mean that's an interesting one. It's not – ultimately, it's all about the economic supply and demand. We know that there are a number of lactoferrin plants coming on internationally that will increase supply. We also know that demand is increasing. So, I do see that lactoferrin pricing will hold for a while but it's a very volatile pricing market. If you look historically, it moves up and down quite rapidly. We – you should not necessarily expect that it will remain at this sort of pricing level for a long time.

Sam Teeger: Got it. And you're guiding to 27 million ton in FY19. Just wanting to understand, what is your capacity at the moment? And for you to get to 27 million from what you've done previously, how much additional CapEx have you had to spend?

Nigel Greenwood: So, you're saying 27 tons of lactoferrin guidance?

Leon Clement: Yeah.

Nigel Greenwood: Yeah. So, that's roughly double what we did. I think we did about 16 ton last year, so it's not quite double the amount that we sold last year. And as I mentioned to you earlier, around about half of that is committed to a contract at a fixed price. We haven't given guidance on what their fixed prices and the remainder will be used internally and some sold on the spot market.

Leon Clement: We should highlight that lactoferrin turns up in the milk stream later in the season. So, the increase that you're seeing in the second half is reflective of how lactoferrin comes through the milk stream through the year. Not a function of the yields or the performance of our plant.

Nigel Greenwood: Yeah.

Sam Teeger: Got it. But that 27, is that your capacity or just how much you're going to produce this year?

Nigel Greenwood: It's not capacity because if you recall, we only commissioned our second plant around November. So, we believe our capacity – well, we basically said each plant has capacity of around 17 ton to 18 ton. So, if they operate efficiently through the whole period, you might have total capacity of around, let's say, 34 to 35 ton per annum.

Sam Teeger: Got it. And sorry, last question, just wanted to understand what you're seeing to give you comfort that [inaudible] registration can be achieved for New Hope for Bright Dairy by the end of this year. Do you have a date yet for the summer[?] inspection?

Leon Clement: Look, I think it's really hard to be definitive on what has been, as you know, a pretty uncertain regulatory environment. It's positive that things are moving forward. We're receiving questions and responses and we just had to work through the process. So, we've carefully worded that we anticipated later this year, but look, I think there's still a fair amount of uncertainty in that climate.

Sam Teeger: Great. Thank you very much.

Operator: We'll hear next from Arie Dekker with FNZ Capital Limited.

Arie Dekker: Good morning. First question just with regard to Pokeno. If the supply that you've secured to-date has followed through, how much will you be taking in in your first season?

Leon Clement: Arie, do you mean the supply that is contracted to-date or the supply that we anticipate?

Arie Dekker: No, it's the contracted supply at this point. If they don't decide to go back to Fonterra between now and then, so probably indicated is what I'm after. How much would that be?

Leon Clement: Yeah, we're not providing guidance on what we have and haven't recruited. Obviously, that's still sensitive to us. But look, we will remain really positive on recruiting the milk supply that we need to meet the expectations that we set for the Pokeno start-up. So, we're on track. Obviously, we're working through it. We have commitments in the hand and we're working through a range of other opportunities with milk suppliers. We're a long way through those commitments with a fair amount of time to run before we pile up that factory.

Arie Dekker: Okay. With regards to Dunsandel blending and canning, are you going to be extending that this year?

Leon Clement: That's not currently in our plans this year. We're obviously looking at how we manage the mix of capacity across our network and plans for the future. It's not something that we would rule out. I would stress that we've made some very strong – the manufacturing improvements that I referred to apply for both our driers and our canning lines and the team have done a great job on lifting performance from the existing equipment that we have there, which has played a strong role in us meeting existing demand.

Arie Dekker: In terms of FY19, if you do the upper end of the range, it's sort of 45,000 tons of finished IF. How much of that will be done at Dunsandel to give a bit of an indication of the current capacity?

Leon Clement: We optimize our splits based on optimizing the manufacturing assets we have. So, the guidance that we're providing will be manufactured in terms of blending canning across both our Dunsandel and Auckland sites.

Arie Dekker: But how much of that will be at Dunsandel?

Leon Clement: Well, we optimize that based on shift capacities and plants. We tend to run Dunsandel closer to capacity just based on historical shift patents and networks. And any additional demand is channeled through to Auckland. But as we continue to have optionality there, we'll try that off. I think that you could broadly assume that two-thirds of our volume sits with Dunsandel and the remainder being Auckland. But look, we'll move that mix based on planning decisions and how the guys tend to work that through. So, that very much might change.

Arie Dekker: Sure. I guess, with regards to your guidance, it's not particularly helpful given that NPAT sort of doubled or almost doubled in FY18. And obviously, it's slightly down in first half of '19 but that would have booked second half '18 on finished IF. Can you just sort of confirm that you're pretty comfortable with where consensus sits at the moment at around high 80s for NPAT?

Nigel Greenwood: Look, we're not – we don't provide specific guidance around NPAT, as you know, and what – rather provide guidance around infant volumes. What you should assume is that we are relatively comfortable with where consensus guidance is at the moment. And if we would not, we would be saying something different. So, I think I'll just leave it at that.

Arie Dekker: Sure. And then going to the finished infants, can you just talk to what the powders and cream margin was in the first half ‘19? I know you won’t give absolute levels but just where that margin sits relative to first half ‘18 and second half ‘18?

Nigel Greenwood: It is – just getting the slide up there. That information is available on the pack in the appendix, where we provide – it’s on page 30. But if you’re talking powders and cream, first half FY18 was – powders and creams was 1,192 and first half FY19 was 959. That is sitting on page 30 of the –

Arie Dekker: Yes, okay. Sorry, I should have looked that slightly differently.

Nigel Greenwood: Okay.

Arie Dekker: I should have – in terms of the ingredients margin.

Nigel Greenwood: When you say the ingredients, you mean excluding our infant bulk product? Is that what you mean?

Arie Dekker: Correct. Yeah, correct.

Nigel Greenwood: We don’t disclose that.

Arie Dekker: I know you don’t disclose the absolute level but can you just talk to what the relativities were between the periods?

Nigel Greenwood: When you say relativities, do you mean the volume that we manufactured – or sold? Is that in terms of margin?

Arie Dekker: Margin relativity. Ingredients margin is – does have pluses and minuses.

Nigel Greenwood: Yes, I know.

Arie Dekker: I guess I'm interested in where margins in first half '19 sat for ingredients – commodity ingredients versus the two previous periods?

Nigel Greenwood: As I said to you, we don't provide that guidance, Arie.

Arie Dekker: Okay. Fine.

Leon Clement: I think we'd stick with what we've shared, which is obviously there's been a contractual renegotiation on our end. I think we've had discussions on how that might've impacted margins in the category and broadly we maintain that position but for obvious reasons we don't disclose that.

Nigel Greenwood: But I think I'll go past to say because the powders and cream, as you know, includes the infant milk product that we sell externally as one of the infant milk product that we sell internally [inaudible] price to our consumer package and therefore the reduction in the overall margin per ton that we have achieved on our infant does mean that the ingredient margin per ton that we've achieved in the first half has improved. So, that's the guidance that I can't give. It has improved on the ingredient margin per ton that we achieved in the first half last year. I'm happy to say that.

Arie Dekker: All right, that was sort of what I was asking for. Thank you. Sorry, that I didn't make it clearer. And final question, what was the base –

Nigel Greenwood: I thought you were looking for more specifics on that.

Arie Dekker: Yeah, what was the base IF volume in first half '19?

Nigel Greenwood: What was what volume?

Leon Clement: 17,684 ton.

Arie Dekker: Volume external.

Leon Clement: 17,684 ton. It's on the outlook slide on page 25. Is that what you mean?

Arie Dekker: No. Sorry, this is a really bad line which obviously isn't helping with the repeating. The base infant formula volume –

Nigel Greenwood: Yes.

Arie Dekker: External sales in the second half – sorry, in the first half.

Nigel Greenwood: The amount that we sold externally is base powder.

Leon Clement: Yeah, that's right.

Nigel Greenwood: Sorry, your questions are just not all that clear. So, I think that's what you're asking. We sold, I think, around 3,500 to – around 3,500 to 4,000 ton of base powder externally in the first half FY19 and my recall is roughly about 1,000 ton in the first half FY18. Is that the question you wanted?

Arie Dekker: Yeah, thank you.

Leon Clement: Great. Thanks, Arie. Should we go to some other calls?

Operator: We'll go Luke Mills with Craigs Investment Partner.

Luke Mills: Good morning guys. Can you hear me all right?

Leon Clement: Yes, we can. Thank you.

Luke Mills: Cool. Perfect. So, you obviously reiterated your full year IFC guidance. Second half implied is 25,000 metric tons. Just from manufacturing standpoint, could you just, I guess, kind of bridge how this is possible in terms of GACC approval for Auckland and kind of what timing you've got built in to that range there, the 23 to kind of 27? And then just building on that, within your finished goods volume, it kind of looks like you've got about 2,000 metric tons of IFC. Does this gives you like a little kick-start heading into the second quarter? Is that a right read-through?

Nigel Greenwood: Well, I think there are two questions there. In respect of can we meet the increased demand for our existing capacity without the approval on the – assuming we don't get the approval, the GACC approval on the Auckland operation, the answer is absolutely yes. Leon has already indicated that we're managing optimization of the use of our assets to meet our customer demand and we'll continue to do that and we have no concerns around that. So, that will not be an impediment to customer growth.

Second question was around – what was the second question again?

Luke Mills: Just on your finished goods inventory.

Nigel Greenwood: Finished goods inventory. So, there –

Luke Mills: Finished goods inventory.

Nigel Greenwood: So, there's a lot of feedback on there on those. In finished goods inventory, yes, at the half year, there is fully finished infant canned products sitting in inventory. And I think the way to think about it is that is there're normally – we normally hold around three weeks of finished infant formula in our inventory at any one point in time. And that's really just a timeline between completely manufacturing it, getting it into the warehouse, awaiting testing results before we're in a position to deliver to customer. So, depending on our monthly volumes of total sales volumes will depend on how much two to three weeks of inventory might reflect. But you can probably work that out.

Luke Mills: Okay, thank you. Just one final question. Just thinking about the second half kind of IFC customer stats, you called out continued growth in a2 and then Munchkin sales into ANZ. But I noticed you hadn't mentioned your Chinese IFC customers. I know that in the previous results, you talked to this as a slight swing factor on a SMR[?] approval in the second half. If you look that out, it's the right read-through that's no longer in the range or that's just not called out?

Leon Clement: That's essentially the right read-through. With the uncertainty in registration of those brands, it's difficult for us to call that. As we said, we anticipate registration in 2019. Whether or not that falls into the full financial year or not is still unclear.

Luke Mills: Perfect. Thank you. Adrian, just got one more, sorry.

Adrian Allbon: Can I just ask a couple of follow-up questions? First one for you, Nigel. Just on the finished goods inventory that sits on the balance sheet at the first half.

Nigel Greenwood: Yeah.

Adrian Allbon: Are you trying to signal to us that there's more than three weeks' inventory there sitting at the moment because relative to our numbers, it looked like your first half delivery was a couple of thousand short.

Nigel Greenwood: Couple of thousand short of what?

Adrian Allbon: Metric tons, like we would expect to closer than 19,000 metric tons in the first half. I'm just wondering whether you've got more sitting at finished goods inventory than you would normally have?

Nigel Greenwood: More – which product though are you talking to?

Adrian Allbon: So, the IFC product.

Nigel Greenwood: So, we would have – so in our finished goods inventory, we will have fully finished infant canned product. We'll have infant bulk and bags either to be sold externally or to be used in the manufacture of fully finished infant product and we'll have ingredients products being whole milk powder, skimmed milk powder and AMF. So, that's predominantly with infant. So, I'm unclear as to specifically what you're asking.

Leon Clement: I think it's important to recognize that we continue to optimize our supply chain, and work that we do across that may mean that we shift inventories from us to our customers over time and there may be a read-through if you're taking first year '18 as a base line there.

Nigel Greenwood: What I've seen is that the –

Adrian Allbon: Okay, maybe I'll just follow that up.

Leon Clement: Yeah, I suggest we pick that up offline and we can perhaps just work through the basis for your calculation and give you some context. But look, I think the lack of clarity here suggests that we're not sitting here thinking we're going to have a big start. Our inventory levels are normal based on how we run our organization. And look, I think that we got to be careful not to think that there's a like-for-like relationship between sales of our customers and the way our sales move through, likewise inventories move up and down between supply chain partners and our organization. But we're carrying an appropriate level of inventory if that's the question.

Adrian Allbon: Can I just ask – that's fine. Can I just ask, just on the reduction in the – what looks like the IFC margin on a gross margin per ton. I've got three key drivers here effectively the a2 renegotiation, the lower proportion of other IFC customers which are typically the higher [inaudible] and then thirdly the fact that you're probably carrying an underutilization on the Auckland plant.

Nigel Greenwood: Right. So, in terms of the impact on – yeah, actually the answer is yes to all three, yeah. So, it is all three of those. Yeah.

Leon Clement: Yeah, I think it's a good assessment.

Nigel Greenwood: Yeah. Can't argue with them, yeah.

Adrian Allbon: And just then on a follow-up on that as how much of the drag on the underutilization of the Auckland plant?

Nigel Greenwood: Well, one way to think about the underutilization of the Auckland plant that maybe helpful for you to think about, if you look at the gross profit by category slide, you see the consumer packaged gross profit per metric ton. And the Auckland site was not fully utilized has not significantly impacted the margin per ton that we're generating on our infant in terms of the packaging part of our infant process.

So, what that tells you is that we're increasing our efficiencies in other ways, and at the same time effectively maintaining our margin and that part of the business, notwithstanding the fact we've got increased capacity that is not fully utilized. So, I think the read-through there is that through – that we are maintaining our margins in that area despite that. Does that make sense?

Adrian Allbon: Yes, thank you.

Operator: We'll hear next from Jonathan Snape with Bell Potter.

Jonathan Snape: Yeah, hi guys. Just two questions, if I can. Just on CapEx in the second half, what your expectations are for that to land. Following on to that, Nigel, can you let me know how much interest is capitalized in the first half result?

Nigel Greenwood: Could you just speak up, Jon?

Leon Clement: How much interest is capitalized in the first half?

Nigel Greenwood: Look, I don't have the – sorry, I just had that. Leon just mentioned that you're asking about the amount of capitalized interest in the first half. Look, I'm sorry, I don't have that number directly to hand.

Leon Clement: First question.

Nigel Greenwood: But we can follow-up with that.

Jonathan Snape: Okay. And just what your expectations are around – yeah, and your expectations around capital expenditure in the second half where you think it's going to come in?

Nigel Greenwood: Look, we haven't specifically talked about capital expenditure in the second half but what we have done is I've given a guidance on where we expect net debt to fall. So, you will see that net debt is likely to fall – we're targeting between $320 million and $340 million overall of net debt. So, that effectively will take into account our forecast capital expenditure as well as our operating cash flow that we'll generate in that second half.

Jonathan Snape: Okay, all right. Thanks.

Operator: We'll hear now from Alan Williams with New Zealand Farmers Weekly.

Alan Williams: Yes, there. Hello. Your commissioning your dairy packaging plant in Dunsandel. Just wondering when will that start, what sort of products will [inaudible] ramp up and customers you're talking to? And how might the China exports evolve?

Leon Clement: Great, Alan. Can I just repeat the question and check I've got it right? You're asking about timing for firing up the new Dunsandel liquids plant and the profile of customers emerging from there; is that correct?

Alan Williams: That's right. And how the China exports might evolve looking for registration there as well.

Leon Clement: Okay, great. Look, we look to be transitioning and commissioning the plant – it's been running through commissioning now. We look to be making initial sales and transitioning until our commitment with FoodStuffs South Island through April. And that's really starting with the fresh white milk category that we entered into with that partnership. We will follow later with the other categories that we're developing there and perhaps that's piling of commissioning of that specific line, but it also relates to the development timeframes required to work on both the customer opportunities and the categories that we're developing in those spaces.

And I would qualify that whilst we have good relationships and exposure to China currently, we are thinking more broadly around the market set for which we provide those opportunities. And again, those three to four categories that I mentioned in the presentation around functional creams, ambient drinking yogurts, ready-to-feed infant nutrition and functional beverages are what we're targeting.

We would expect that some of those products would be starting to come online later this year. And as I said, we'll be exploring multiple market category and customer combinations with that.

Alan Williams: That's great. Thank you.

Leon Clement: Thanks Alan.

Operator: And from Forsyth Barr, we'll hear from Chelsea Leadbetter.

Chelsea Leadbetter: Good morning. I guess if I can kick-off with just clarifying a little bit with respect to your guidance on OpEx for the second half. I appreciate you said you're expected to lift again. Can you give us a bit of – I guess, a range or a quantum as to how we should think about that?

Nigel Greenwood: Good morning, Chelsea. Yeah, look, what I wanted to indicate is that was that you should expect that our overhead spend or OpEx spend will be slightly higher than what we incurred in the first half. So, look, I would think that you might expect it to be somewhere around 10-15% higher, something of that order.

Leon Clement: I think it's important – yeah.

Chelsea Leadbetter: Thank you. And I just –

Leon Clement: Go ahead, Chelsea.

Chelsea Leadbetter: Sorry, the feedback is not helping. I guess we've talked a bit about efficiencies right through this presentation in terms of what you're driving out of your facilities, particularly Dunsandel. I mean can you give us a bit of an understanding about what efficiency opportunities are left with respect to that facility? I mean should we be thinking about this thing as sort of an ongoing topic that we talk to for the next few years? Is there still plenty of R&D initiatives that are coming through that can help continue to improve this?

Leon Clement: Yeah, I think, look, that's a great question and I think the answer to it is, yes, you can expect that and you should expect that. This is, in my view, a world-class integrated manufacturing organization but we continue to expect efficiencies and we want to continue to build that as we go forward. We – as we – with the least programs, when you launch them to looking at how we optimize our operations, the more you look, the more you find. We're excited about the potential that is out there. We're working very closely with the framework called integrated work systems, and that framework is providing some good opportunity for us.

And look, we see a lot of continued opportunity there and we continue to look at opportunities for those investments to optimize our value chain and spaces where we can continue to manage our assets in a better way.

So, look, I think you're right to point to it. And it's evidenced in this result and I'm confident that the team will continue to find improvements and certainly that's what they're aspiring for.

Chelsea Leadbetter: And I guess, to be clear, we should perhaps be expecting that for – perhaps volumes and also a combination of margins?

Leon Clement: Yeah, look, I think it's important to understand that volumes help with efficiencies but you still have to work to realize them, and in some instances, actually more volume can drive cost into your organization and sets you back the other way. So, it's important that I think when you're reading through this result, you look at the investment in the organization both in terms of fixed costs which you already asked about and our capital expenditure. This organization is maintaining its growth profile, delivering improved performance, and at the same time, preparing for growth. And those three streams are, in my view, quite challenging to balance but the organization is doing it well.

Operator: We'll hear now from Aaron Yeoh with Goldman Sachs.

Aaron Yeoh: Good morning, guys. Thanks for taking my questions. First one, just with regards to the powders and creams volume in the first half of '19. Was quite a strong number. I'm guessing part of that – was as a result of extra drier capacity as a result of the slightly lower, I guess, IFC volume. In terms of the full year '19 powders and creams volumes, should we expect that to be higher than the full – than last year?

Nigel Greenwood: Yeah. So, in terms of total production half-on-half what we're saying is that we've actually reduced roughly around the same amount of infant base product in the first half this year as we did last year, but you'll see that we've increased significantly the amount of ingredients that we've produced this year, and that's on slide 19. And the – effectively what we've been able to do is the extra milk that we've been able to process in that first half we've put to ingredients. And that really reflects a response to the demand, but you won't see the ramp-up of infant base powder in the second half being significantly higher than that. Is that what you're asking?

Aaron Yeoh: Yeah, sure so – I mean, I understand the infant – so in terms of like overall volumes done – I mean, should we expect that powders and cream number to be higher for FY19 versus last year?

Nigel Greenwood: Yeah, look. Yeah, well, yes, the answer of course is yes, absolutely. Total production and our total sales volume will be much higher this year than they were last year. We're not signaling exactly what they will be right now. But I am happy to share that we expect to process roughly between 64 million and 65 million kilograms of milk solid in FY19. So, from that information, you could often sort of back-solve what you think are depending on a whole bunch of other variables like inventory levels and things such as that you can try and back-solve the total sales volumes.

Aaron Yeoh: All right, thanks. And just wanted to get some –

Leon Clement: And to clarify because of our – because of our forward forecast of infant nutrition for the second half which is obviously going to be higher, we won't see the same amount of volume produced for powders and creams in the second half. So, that will be lower just to quality that.

Nigel Greenwood: Yeah, so don't take the first half and double it.

Aaron Yeoh: Yeah, no, understood. Yeah. Just with regards to your comment around sort of gross margin improving in the second half as a result of higher infant formula base volumes coming through, in terms of how that looks like versus your reported gross profit by category, effectively are you saying you're expecting that 959 gross profit for tons of powders and creams to be the main delta second half versus first half?

Nigel Greenwood: Yeah, so what you'll see in the second half, you should expect that consumer package margin per ton should remain relatively similar. It might go up a little bit maybe because we'll get it with the extra volumes. We might get more efficiencies through that. So, you might assume that. You'll certainly expect our lactoferrin margin per ton to increase in the second half because of the higher spot sales environment will drive a higher margin per ton on lactoferrin.

And with regard to powders and cream, remembering that it includes three different types of products, so that we don't disclose specifically the individual margins per ton for each type of product within there, but clearly that will increase because there will be a higher mix of infant base products going into fully finished infant formula in the second half. So, that will increase the margin per ton of powders and cream.

Leon Clement: All right. Okay, I think we're just running out of time.

Operator: And at this time, I would like to turn things back to you all.

Leon Clement: Great. Thank you. We're just out of time now. I'd like to thank you for your questions and obvious interest in the business. We look forward to catching up with all of you on the road show. And all welcoming you if you're here to Dunsandel in June some time. So, thanks for your time this morning.

Operator: That will conclude today's conference. Again, thank you all for joining us.