

Converting milk flow to cash flow

Main economic boost to start Q1 2008

- Timing of dairy cash flows will be important for general economy performance.
- Major economic stimulus will occur from early 2008.

The New Zealand economy is set to benefit from a huge windfall from sky-high dairy prices. Fonterra recently announced a forecast payout of \$6.40 per kilogram of milksolids (kgMS) for the 2007/08 season. That will take annual industry dairy payouts to around \$8.5bn, up \$3.3bn (2.0% of GDP) on last season.

Such a massive cash injection will have a major impact on the general economy's performance. We thought it useful to gauge the timing of when farmers will receive the income.¹ We have modelled the anticipated cash flows. To do this we have:

- accounted for timing of production through the season (with peak production from September through January, see *Figure 1*);
- assumed full 2007/08 season industry production of 1344 million kgMS (3% up from last year);
- incorporated announced advance payout rates by month, value add components, and previous season wash-up payments;
- assumed 2008/09 production lifts 2% and payout will be the same as the current season.

When the advanced payout steps up, the increment applies to all of the season's production to that point. For the 2007/08 season, the advanced payout starts at \$3.60 kgMS and gradually rises to \$6.20 by season-end, with an additional \$0.20 in value add.² Peak income occurs November through March, with an additional spike in August as the wash up of the value add component from the previous season comes through (see *Figure 2*).

¹ Behavioural changes are occurring in anticipation of the cash flows, but we expect the weight of cold hard cash in the pocket to have substantial impact.

² Assuming no further upward revisions to payouts. Westpac's forecast is that the 2007/08 final payout will be closer to \$7/kgMS.

Figure 1: Typical percent of dairy production by month

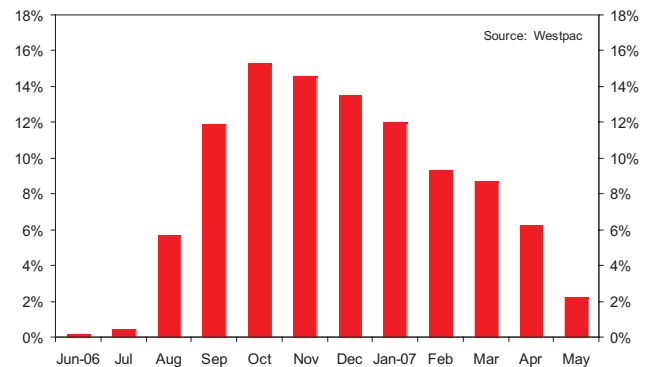
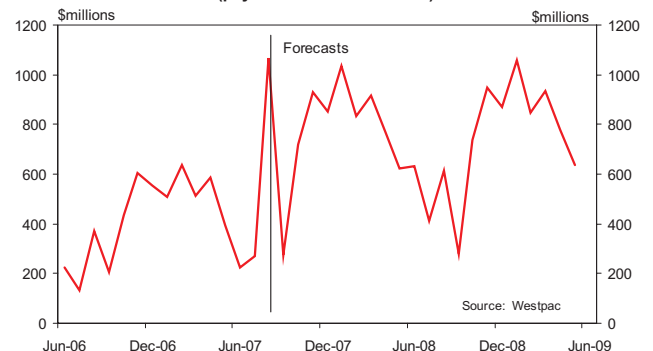


Figure 2: Forecast monthly dairy cash flows (payment 20th of the month)



Coming out of a lean cash flow period and tight balance sheets, farmers are likely to use initial cash flow to restore financial health. However, we expect the dairy income boost to start underpinning general economic activity from Q1 2008. This corresponds to our expectation of a generally poor run of economic data over the coming 5 months, but a strong resurgence from then on.

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