

New Zealand Dairy Board

Presentation to Select Committee

27 July 1999

Introduction & Overview

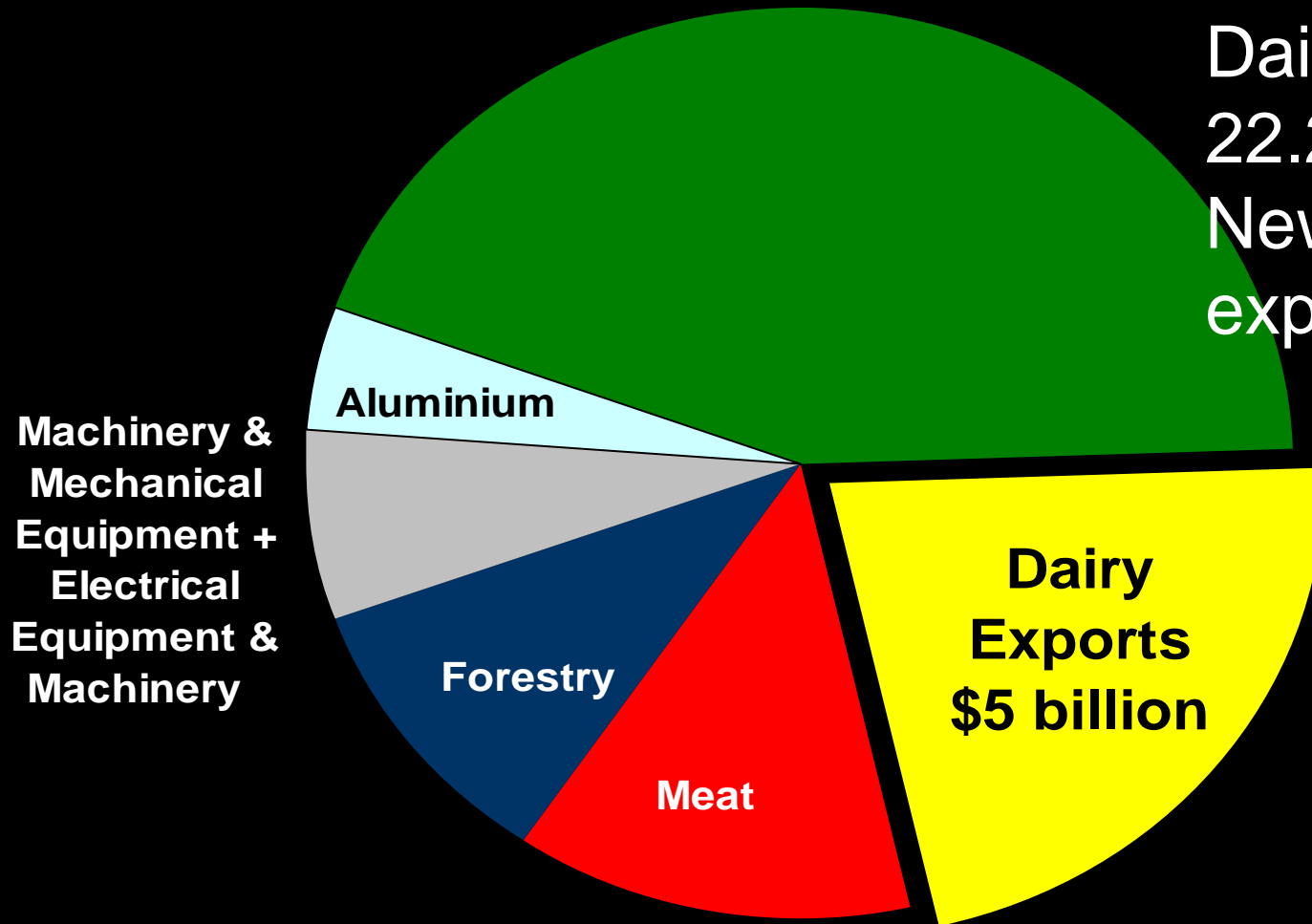
John Storey

Overview

- **Process**
- **Consultation**
- **International Market Situation**
- **Strategy**
- **Co-operatives**
- **Structure**
- **Interface with Dairy Companies**

Importance of Dairy to NZ

Dairy contributes
22.2% of
New Zealand's
export earnings



Process

John Storey

- Process to Date
- Process Going Forward

Process To Date

- **Industry Strategic Plan August 1998 - Feb 1999**
 - **Rigorous process**
 - **Top consultants employed**
 - **Full Industry involvement On Farm to Off Shore Marketing**
- **Industry Structure Project March -May 1999**
 - **How best to deliver the Strategy**
- **Implementation Project**
 - **Dealing with legislation & high level implementation issues**

Process Going Forward

- **Legislation passed**
- **Commerce Commission approval**
- **Merger Proposal Agreed**
- **75% Merger Vote**
- **Integrate merging companies into MergeCo**

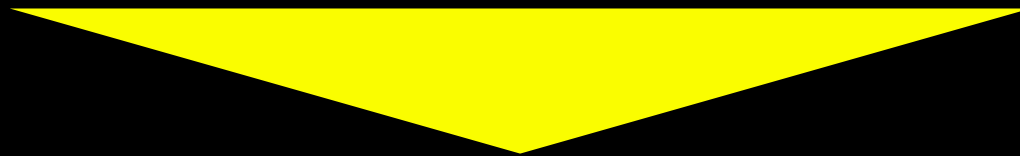
Consultation

John Storey

- Consultation to Date
- Future Consultation

Consultation to Date

- 1998 October - November 15 response
- 1999 March - Strategy
- 1999 May - Structure



Overwhelming support for proposals

In excess of 10,000 at meetings (70% of farmers)

Other Communications

- **Videos (Farming with Pictures)**
- **Written Material - bi-monthly**
- **E Mail**
- **Information via Extension Services**

Future Consultation

- **July/August** - **Company-Supplier Accounts Meetings**
- **September** - **Formal merger proposal to shareholders**
- **September** - **Shareholder vote**
- **Farmer final vote on proposal**

International Market Situation

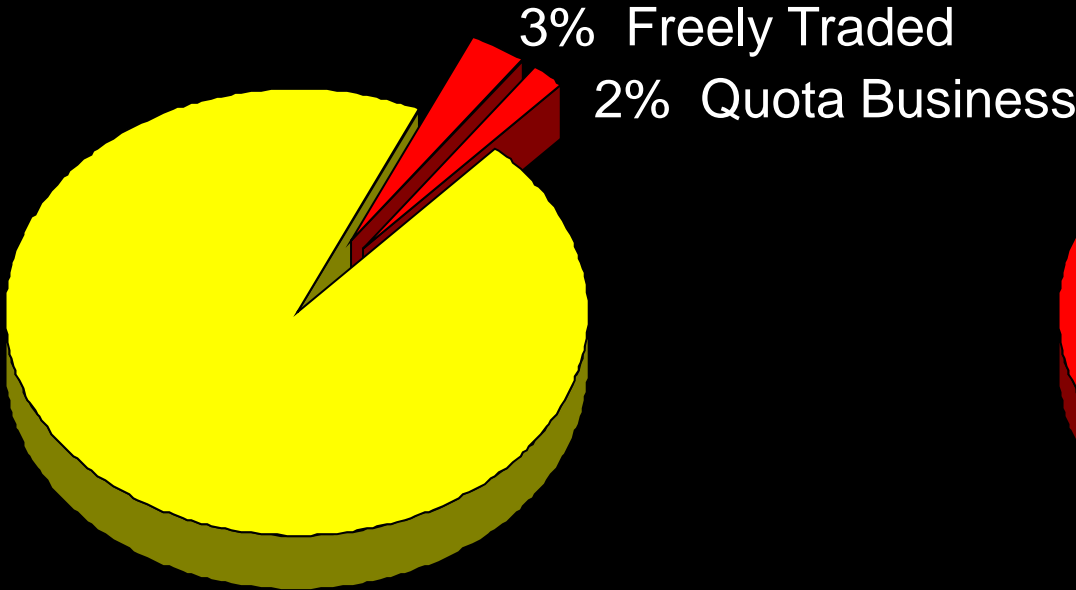
Warren Larsen

- **Milk Production**
 - **Market Share**
- **Access, Tariffs & Subsidies**
 - **Market Trends**
- **NZDB Performance**

Milk Production

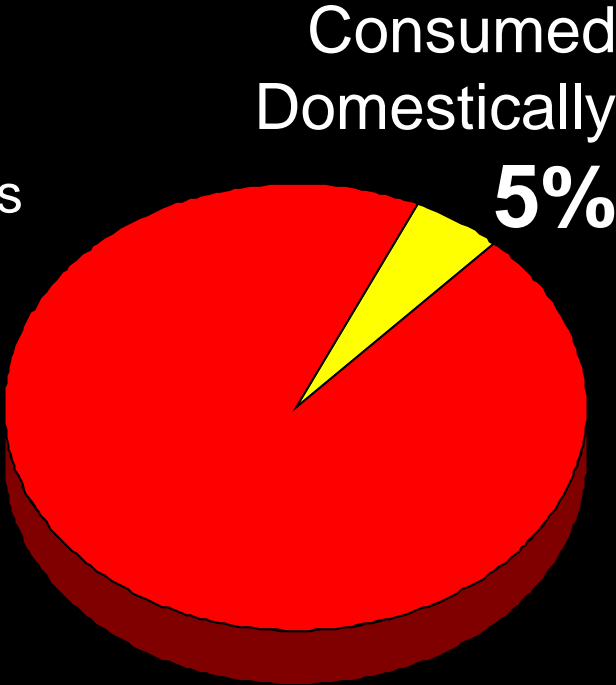
Milk Production

World



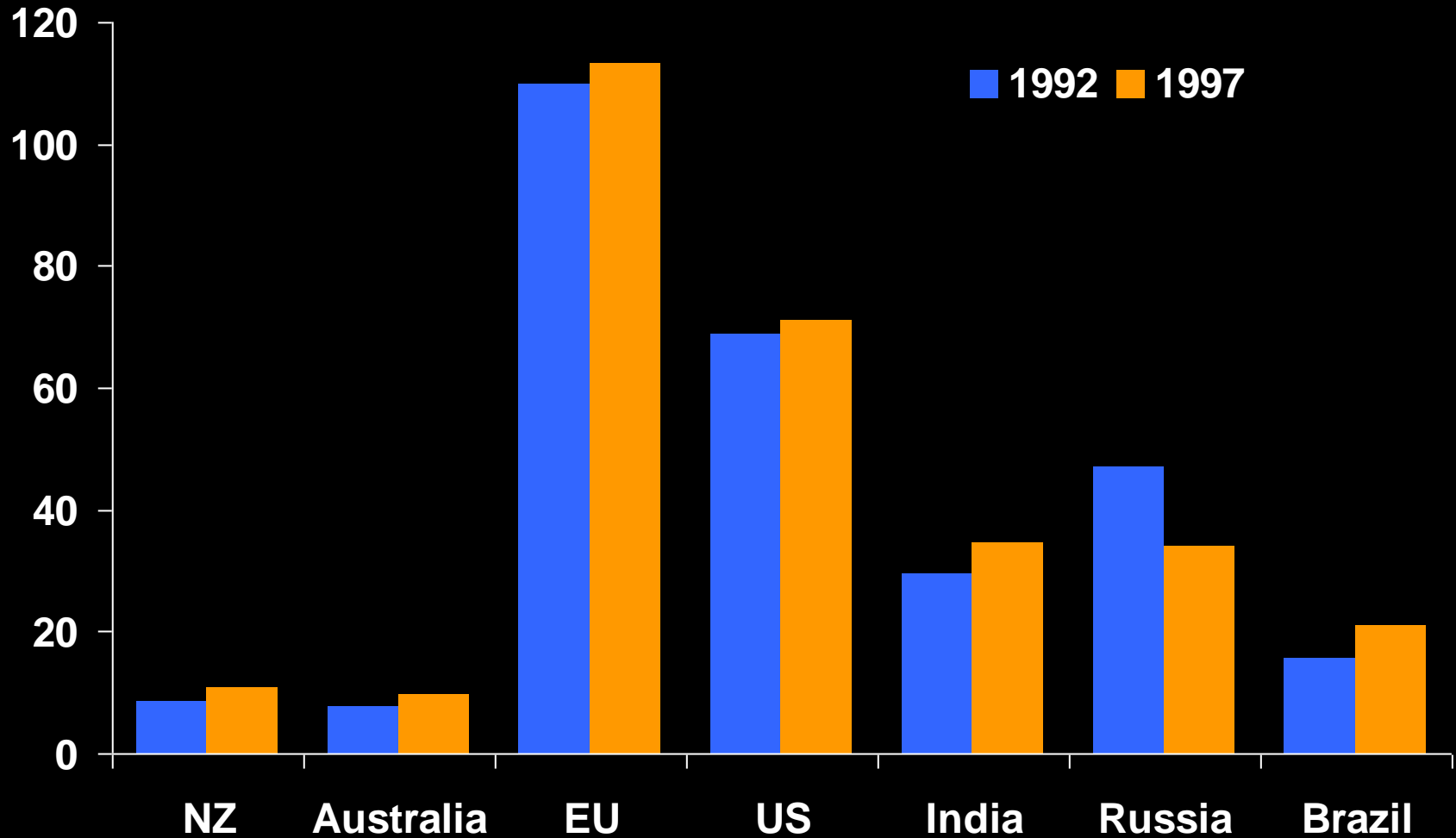
Consumed Domestically **95%**

New Zealand



Exported **95%**

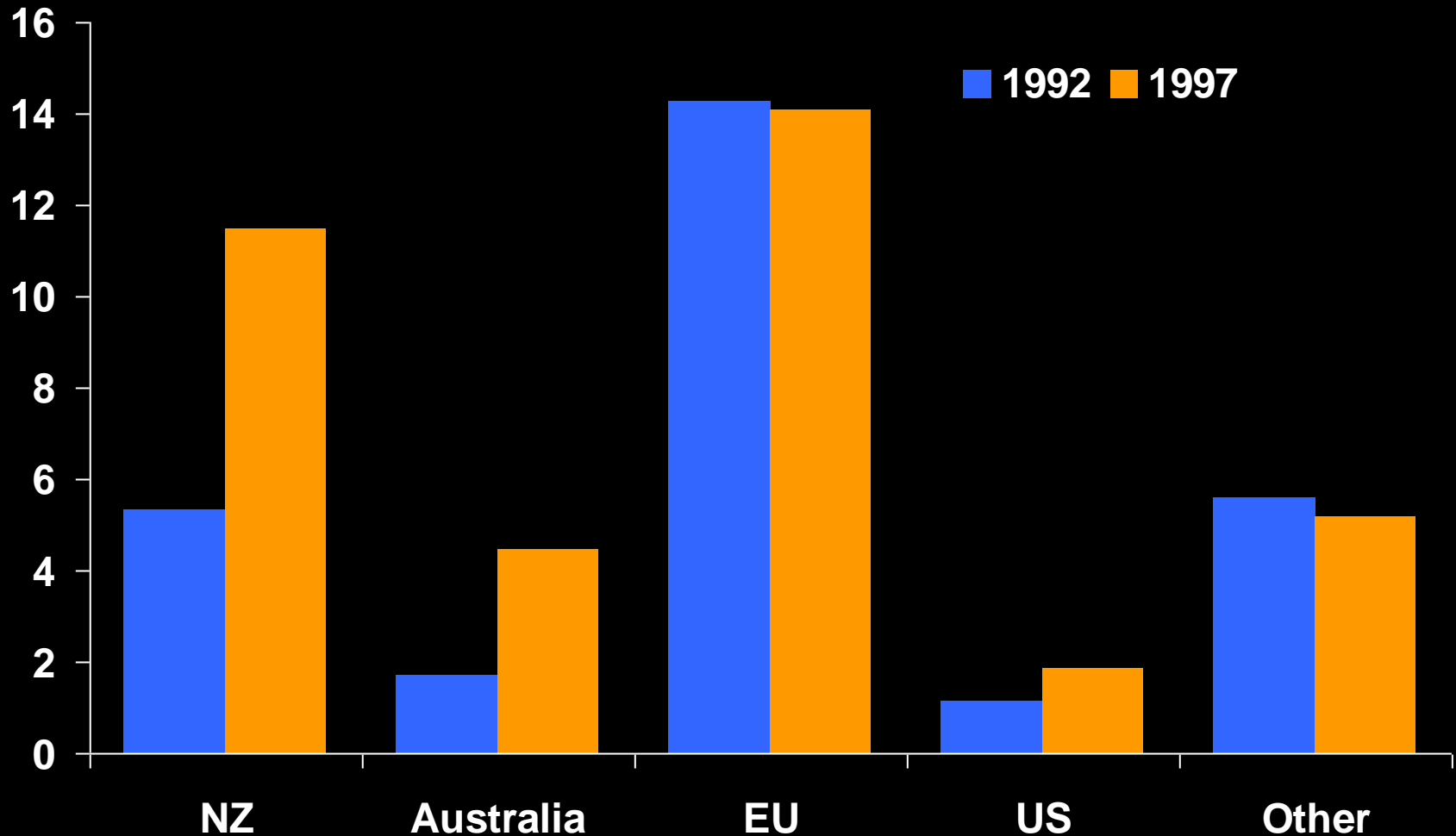
Major Dairy Producers



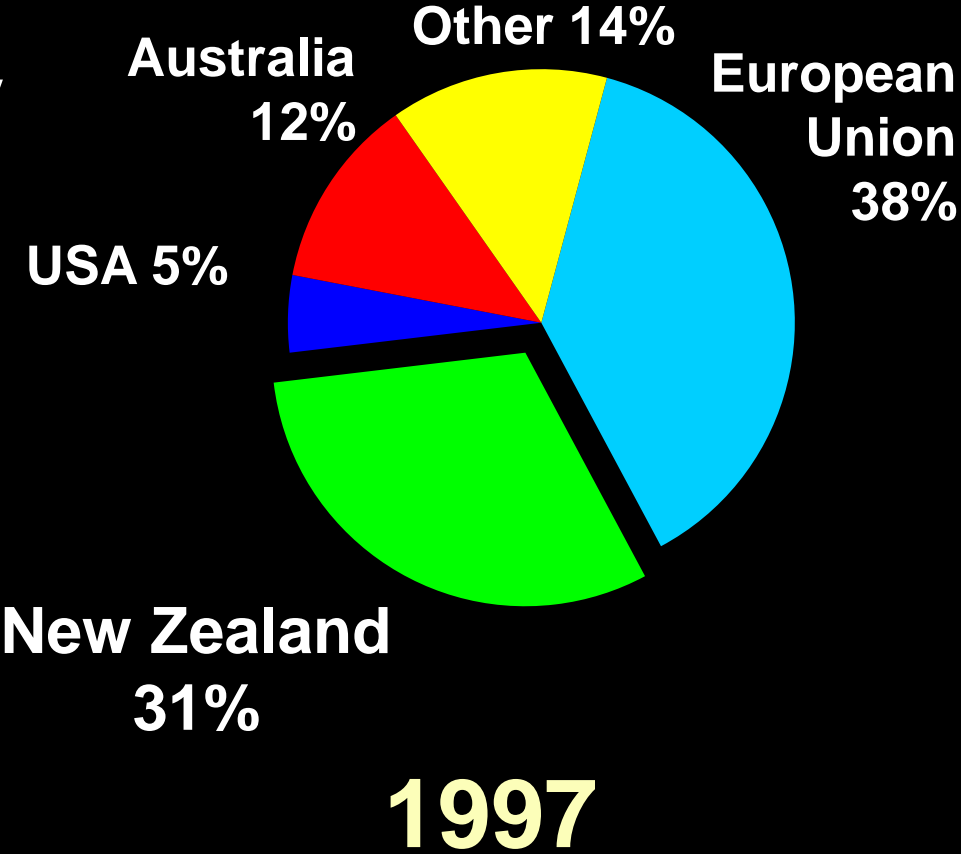
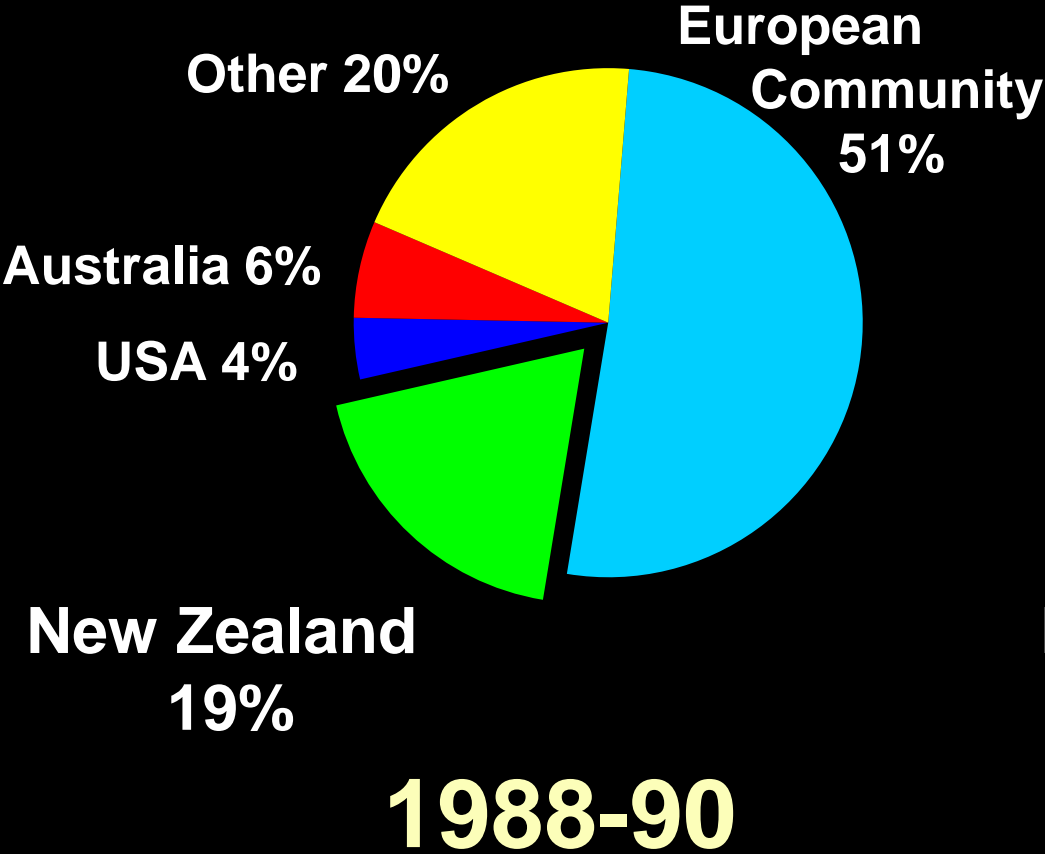
WHO ARE THE MAJOR EXPORTERS?

Major Dairy Exporters

Cow's milk equivalents (million tonnes)



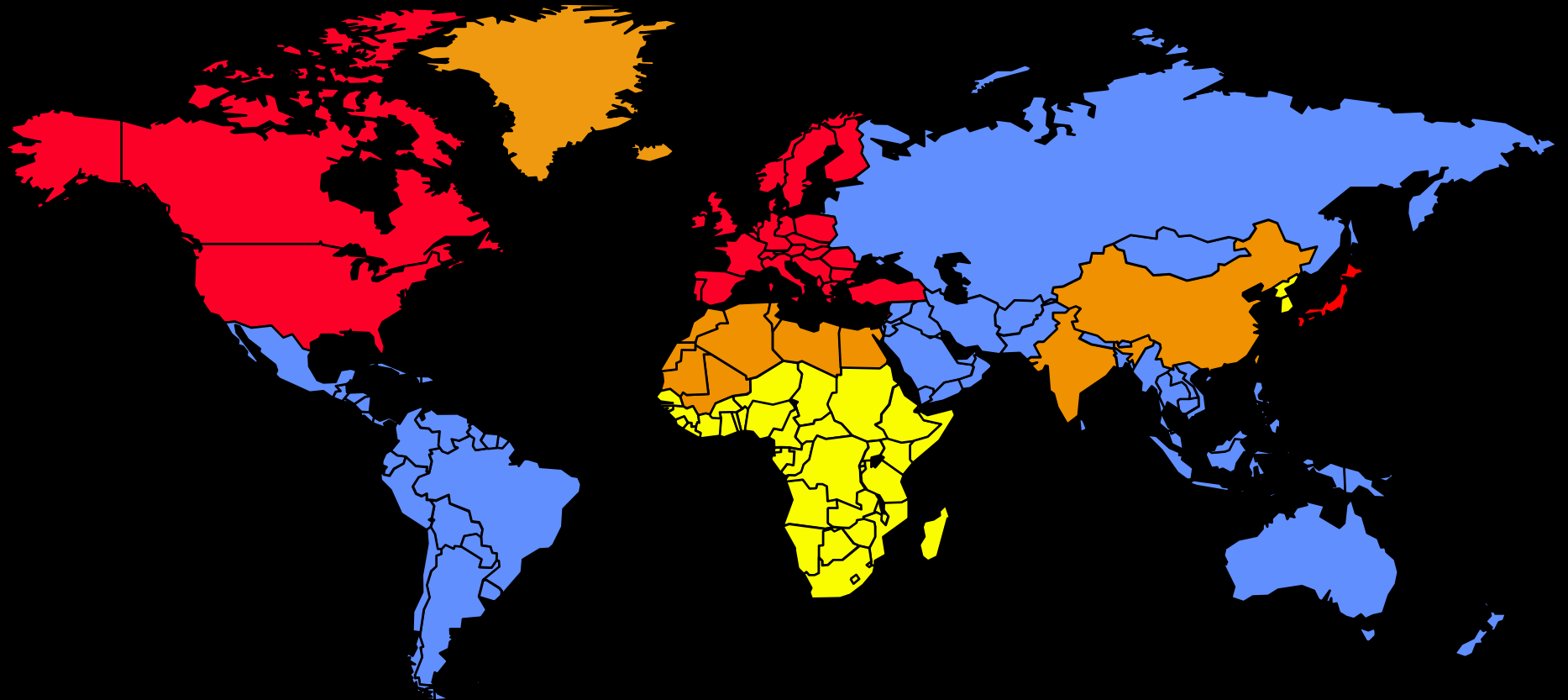
Share of International Trade



DYNAMICS OF THE WORLD DAIRY MARKET

IMPORT PROTECTION

World Dairy Access & Tariffs



- Access All Products/Low Tariffs (0-30%)
- Product Specific Access/Medium Tariffs (30-70%)
- Product Specific Access/Medium-High Tariffs (70-220%)
- Only Butter/Cheese/Protein Quota Access/High Tariffs (>220%)

Protection From Imports

| | <u>Tariff Rate</u> \$NZ/MT | <u>Ad. Val Equiv</u> % |
|-------------------|-------------------------------|---------------------------|
| <u>USA</u> SMP | 1644 | 59 |
| WMP | 2075 | 74 |
| Butter | 2927 | 120 |
| Cheese | 2365 | 168 |

Protection From Imports

| | <u>Tariff Rate</u> | <u>Ad. Val Equiv</u> |
|-----------------------|--------------------|----------------------|
| | \$NZ/MT | % |
| <u>European Union</u> | | |
| SMP | 2539 | 95 |
| WMP | 3173 | 119 |
| Butter | 4200 | 175 |
| Cheese | 3700 | 115 |

EXPORT SUBSIDIES

Export Subsidies: Rates

| | <u>Subsidy Rate</u> <u>\$NZ/MT</u> | <u>%Export</u> <u>Price</u> |
|------------------------------|---------------------------------------|--------------------------------|
| <u>European Union</u> SMP | 1291 | 48 |
| WMP | 1949 | 73 |
| Butter | 3428 | 147 |
| Cheese | 1931 | 58 |

Export Subsidies: Rates

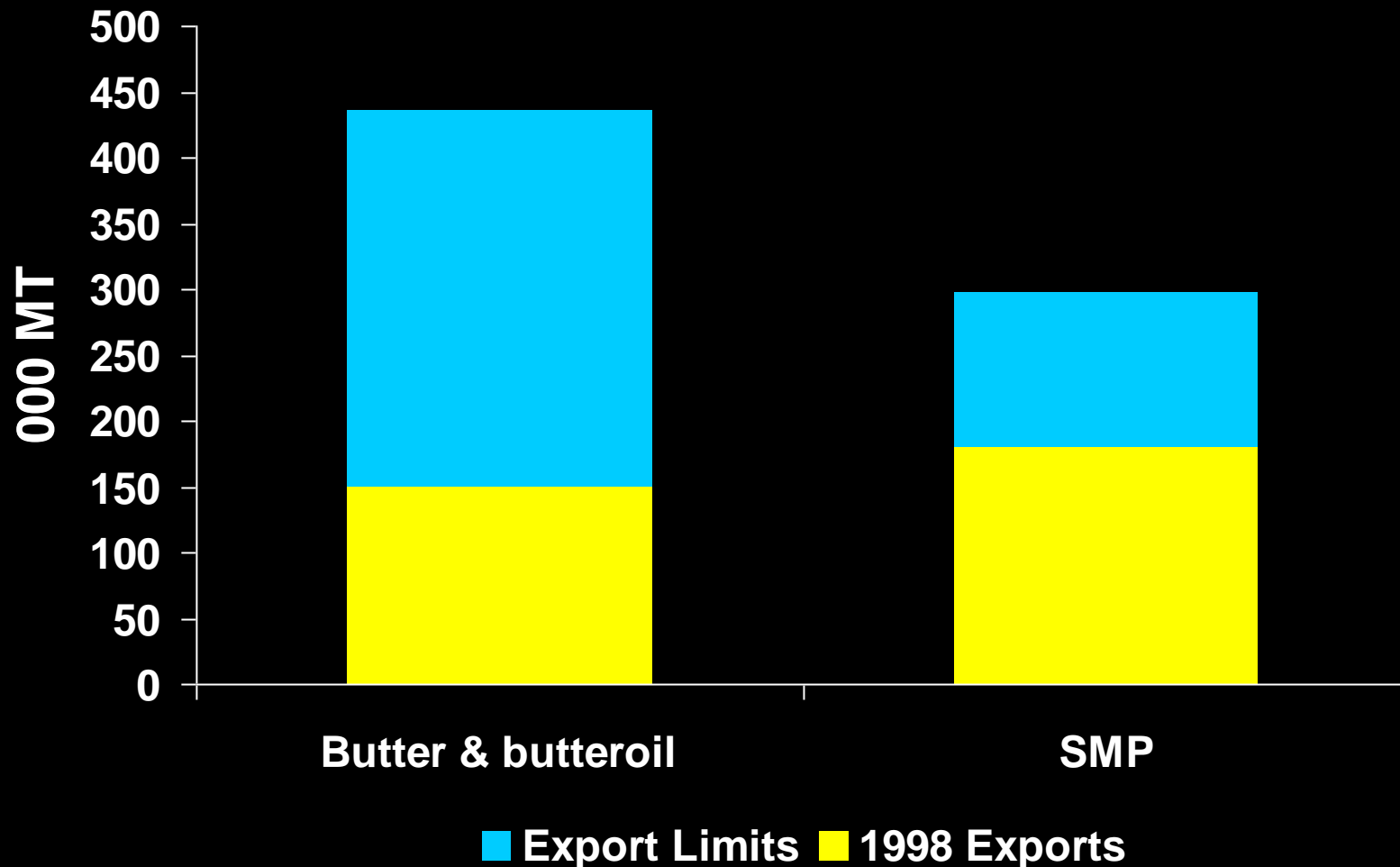
| | <u>Subsidy Rate</u> <u>\$NZ/MT</u> | <u>%Export</u> <u>Price</u> |
|-------------------|---------------------------------------|--------------------------------|
| <u>USA</u> SMP | 2050 | 87 |
| WMP | 2760 | 100 |
| Butter | 2120 | 87 |
| Cheese (cheddar) | 2339 | 67 |

Protectionism

| | Producer Subsidy Equivalent | | Consumer Subsidy Equivalent | |
|--------------------|--------------------------------|------------------------|--------------------------------|------------------------|
| | Milk | All PSE Commodities | Milk | All CSE Commodities |
| Australia | 31 | 10 | -31 | -7 |
| EU | 61 | 49 | -51 | -38 |
| Japan | 90 | 74 | -74 | -50 |
| New Zealand | 2 | 3 | 0 | -5 |
| United States | 52 | 20 | -46 | -10 |

Source OECD Secretariat

EU has plenty of scope to expand



European Butter Pricing (USD/tonne)

- A** **EU guaranteed minimum price** **US\$3072**
- Underpins milk price to farmers of NZ\$9.00kg milksolids
 - Cost of butter to EU exporter
- B** **Export subsidy** **US\$1768**
- Cash payment to export companies (not farmers) paid at time of export
-
- C** **European export price (A-B)** **US\$1304**
- The price we confront in the market

European SMP Pricing (USD/tonne)

A EU guaranteed minimum price US\$2137

- Underpins milk price to farmers of NZ\$9.00kg milksolids
- Cost of SMP to EU exporter

B Export subsidy US\$ 936

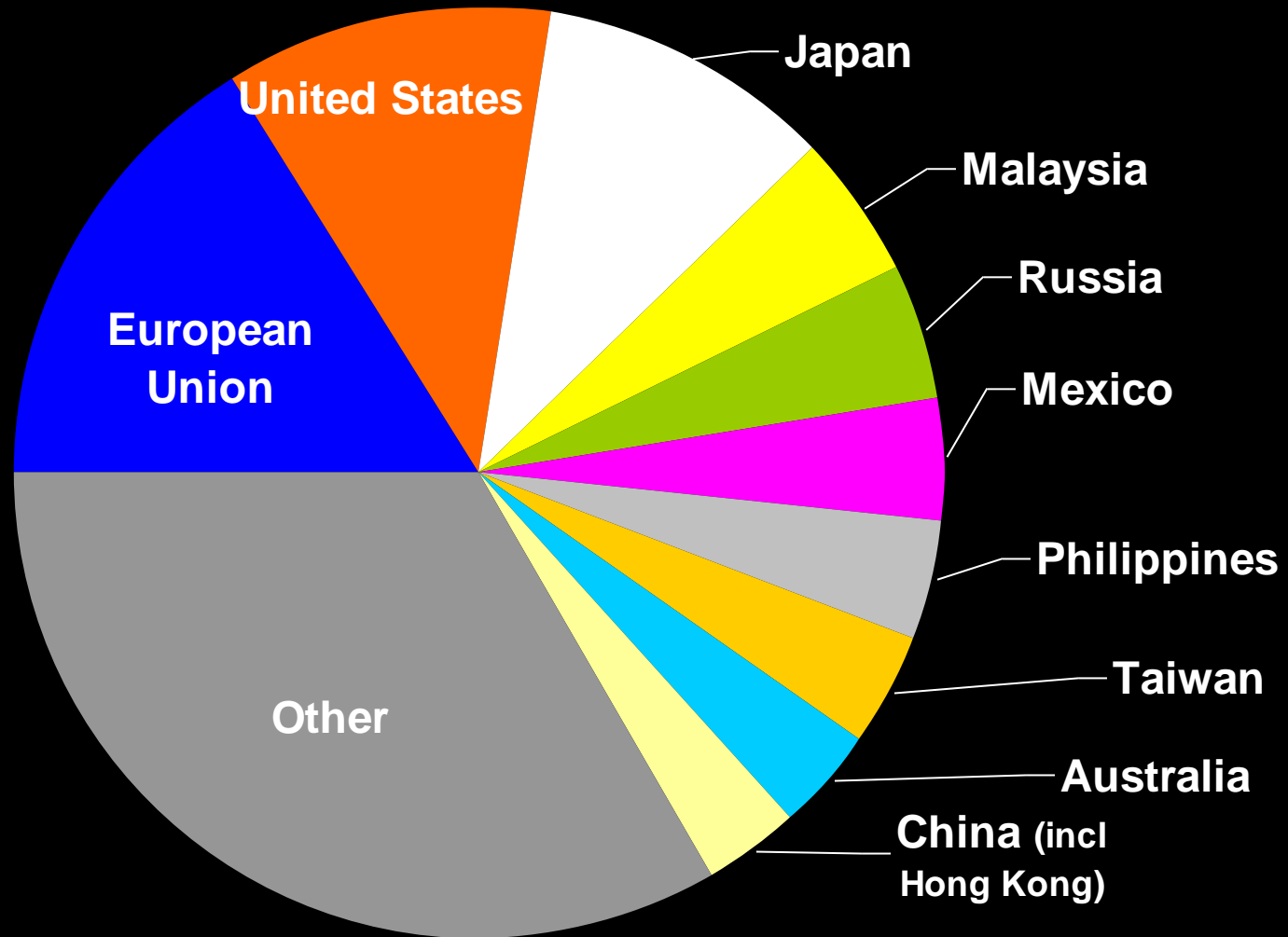
- Cash payment to export companies (not farmers) paid at time of export
-

C European export price (A-B) US\$1201

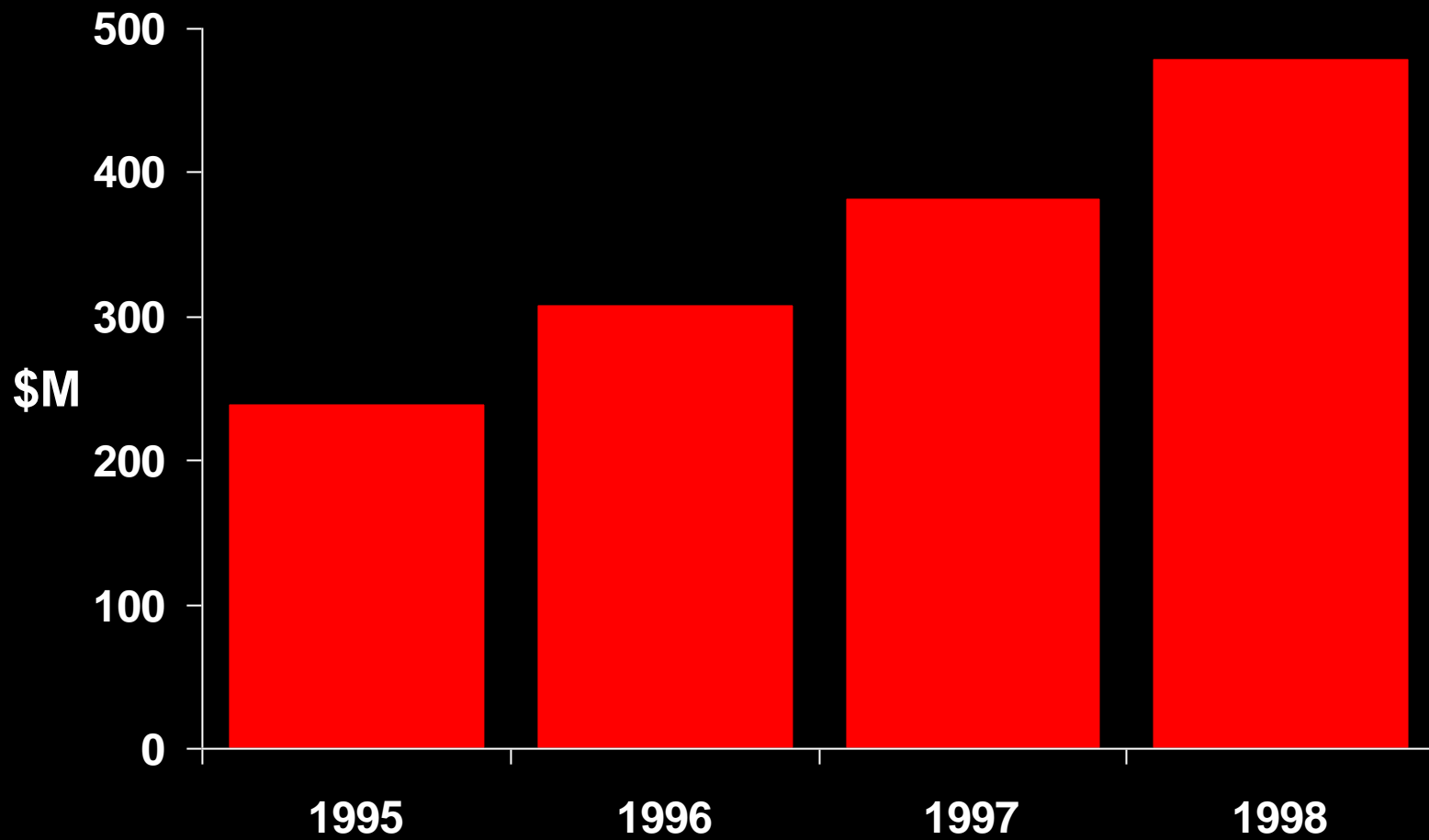
- The price we confront in the market

NZ EXPORT MARKETS

NZ's Dairy Export Markets



Tariffs



IMPACT OF SUBSIDIES ON WORLD PRICE

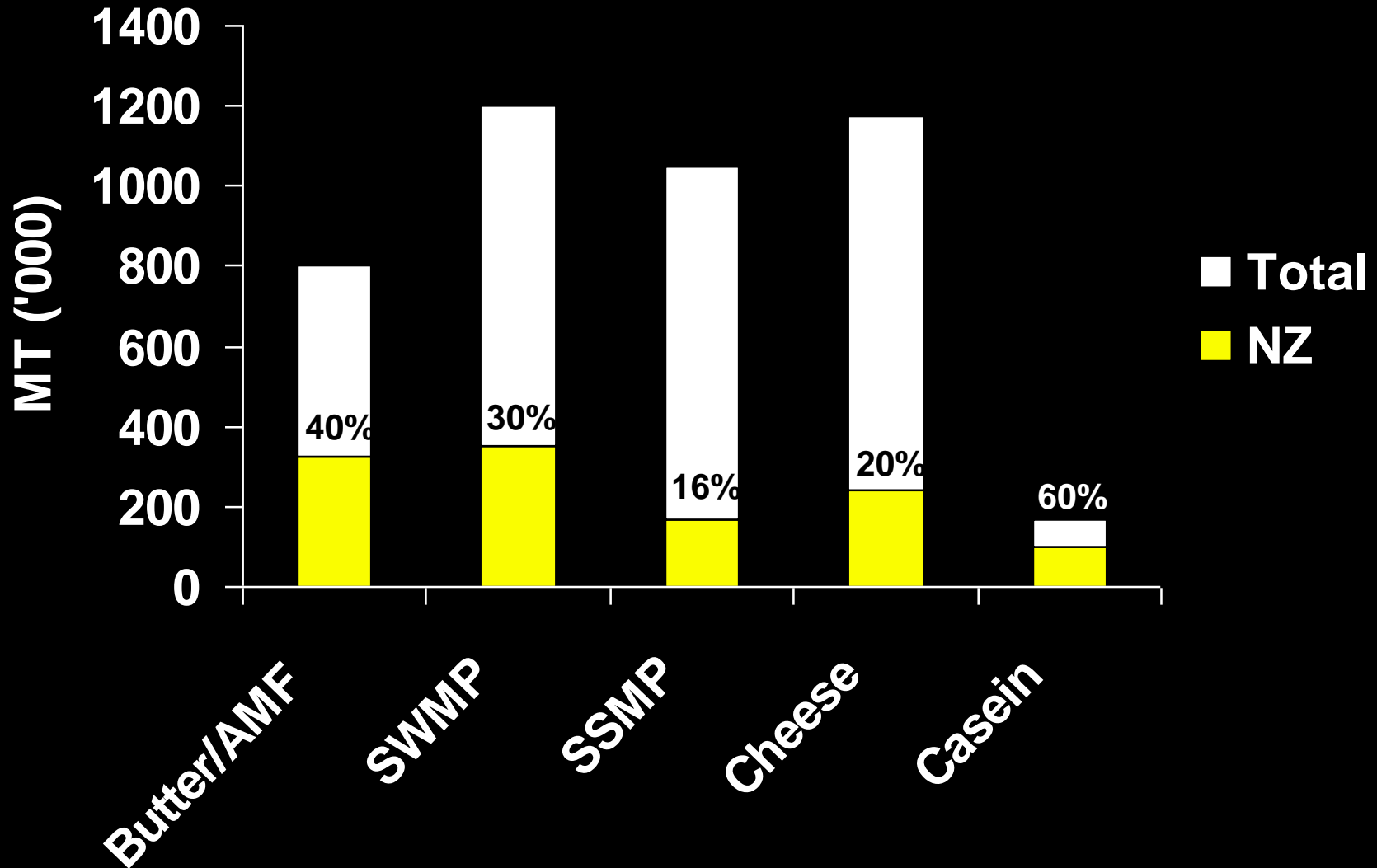
European Union Subsidy Change

**The impact of EU subsidy changes between
1997 - 1999 for Cheddar, SWMP and SSMP =**

NZ\$498 million lost sales revenue to NZDB

NZ PRODUCT VOLUMES

Share of Accessible International Market



**WHAT DOES ALL THIS MEAN FOR NZ DAIRY
FARMERS?**

Forecast World Production

USA - 2+% milk growth
 - low milk prices
 - feed to milk price ratio lowest in recent history

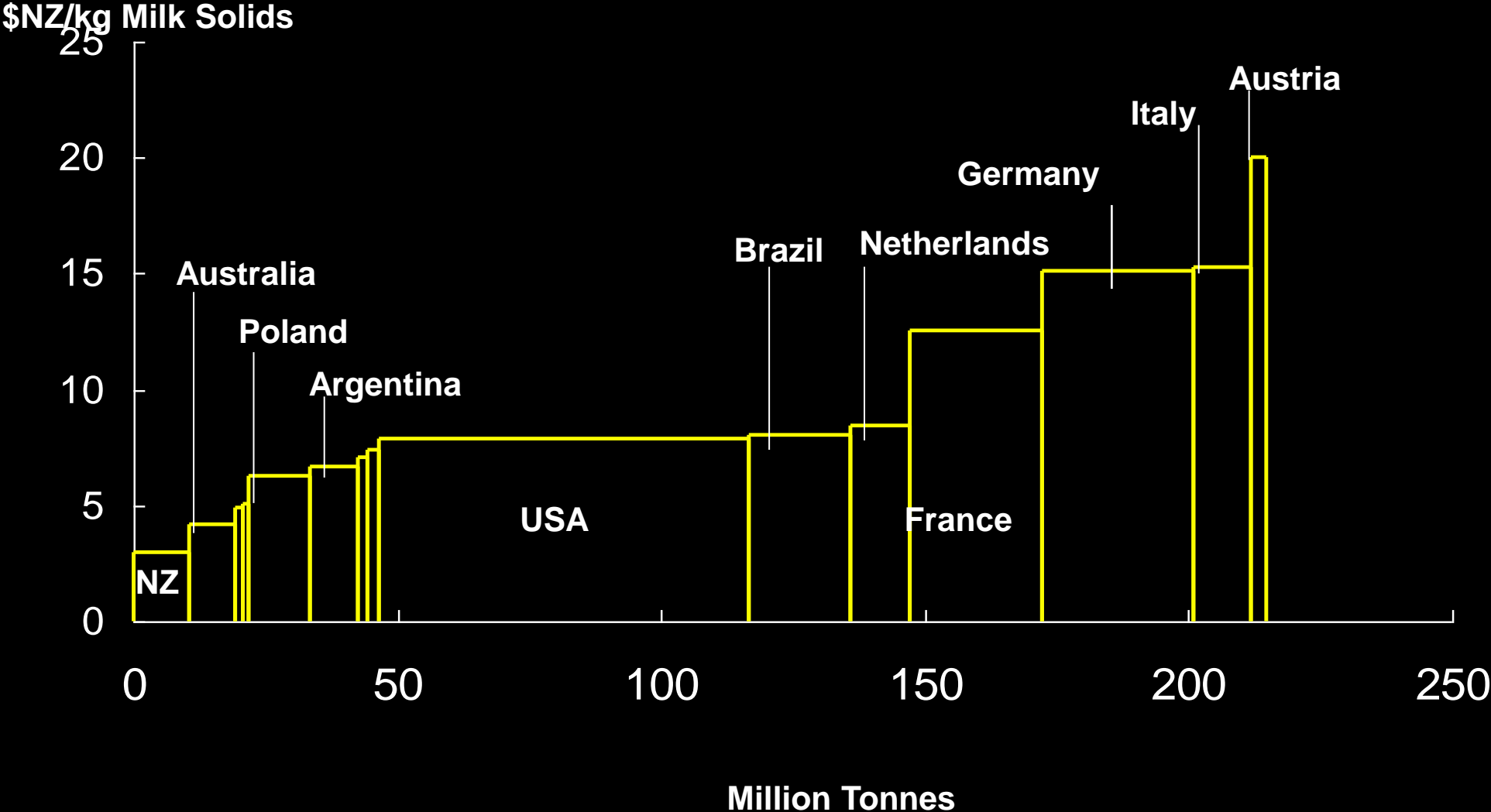
LATAM - 3-5% increase in Argentina
 - small increases in Brazil/Chile

Australia - 4-5% milk growth

EU - no growth

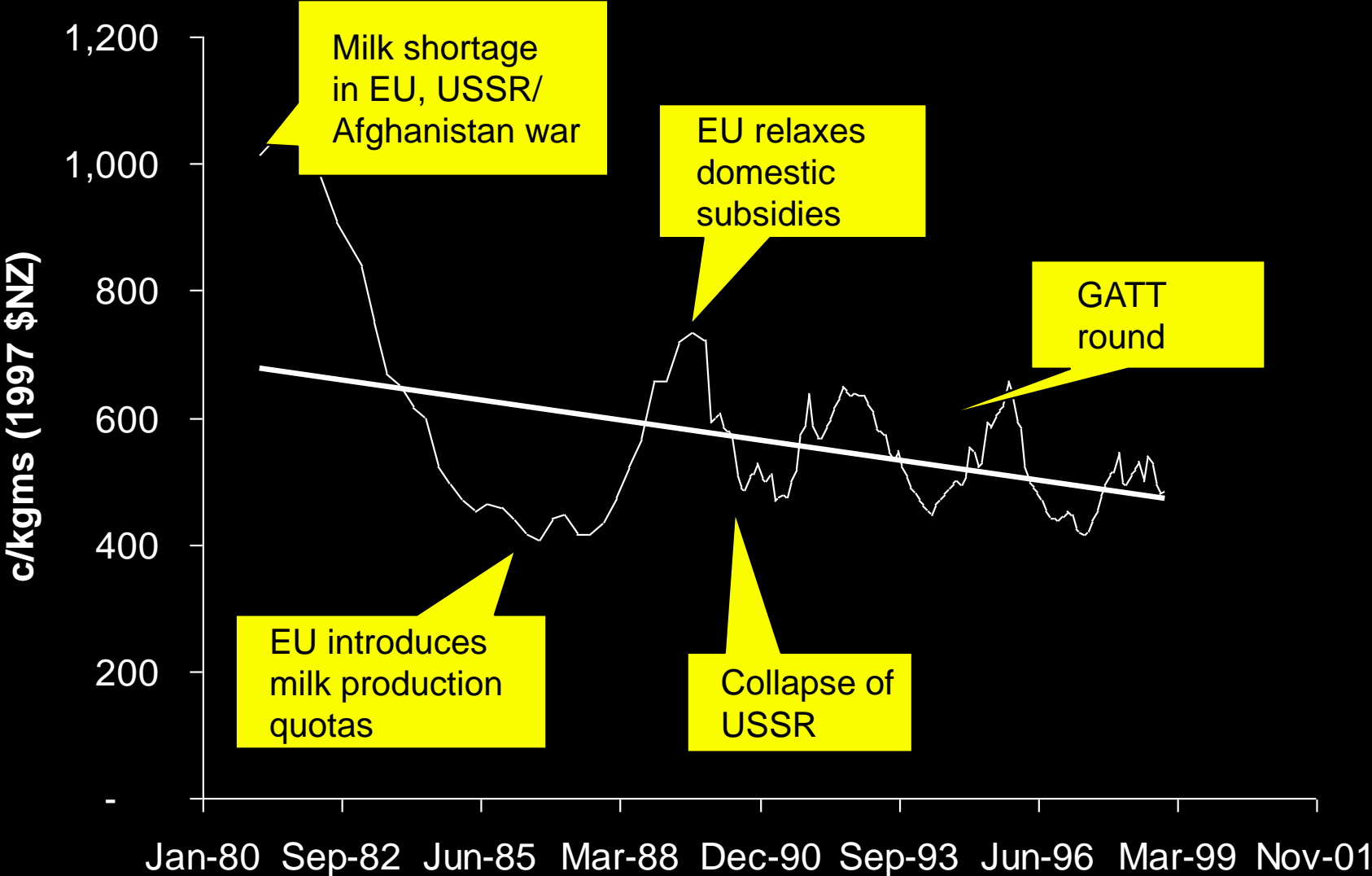
NZ - 4-5% forecast milk growth

Global Dairy Industry Curve

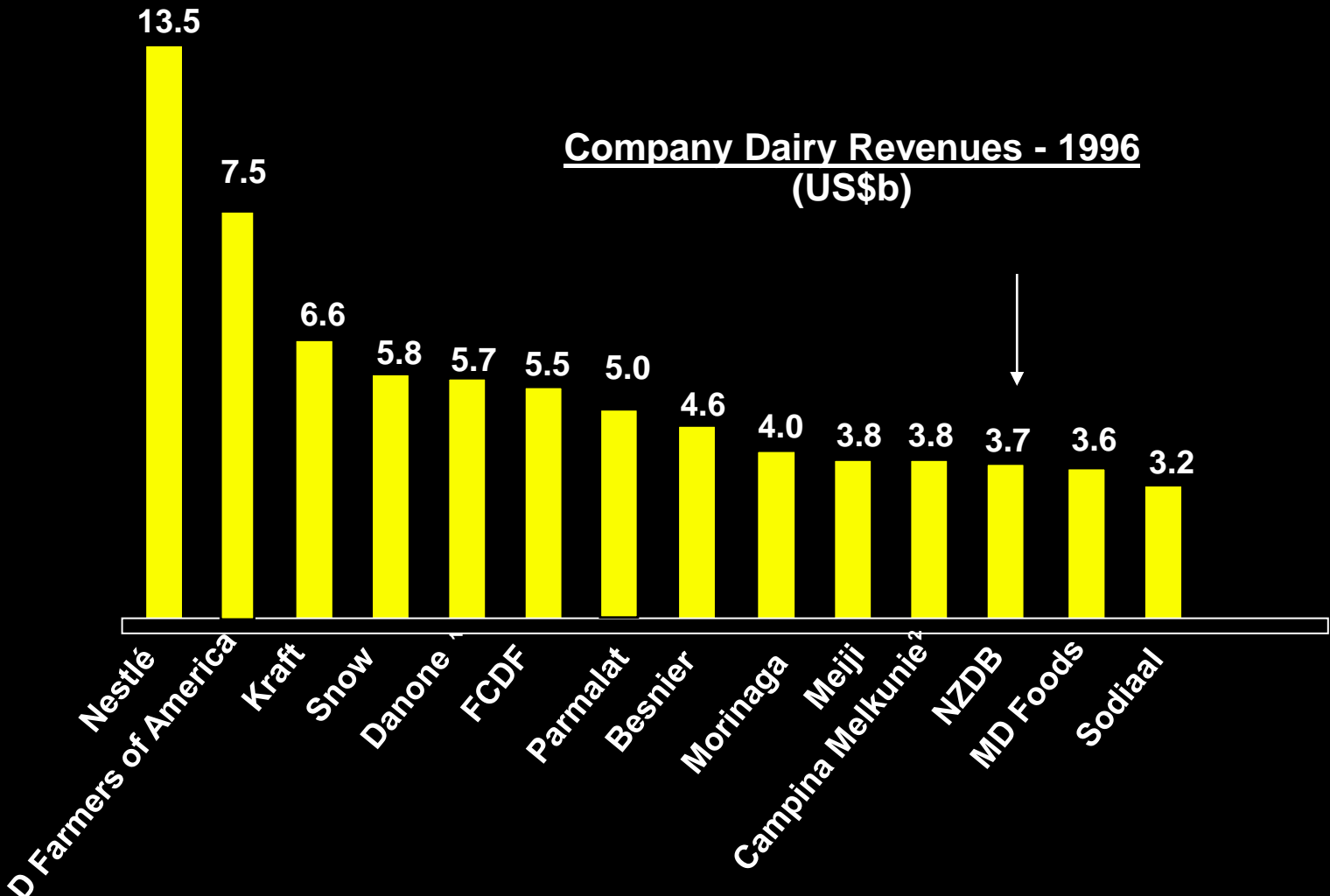


Globalisation Trends

Real Commodity Revenue (1997 NZD)



Leading Dairy Companies



Selected dairy companies = 25%
 Top 20 dairy companies = 35%

Mergers & Acquisitions

Global dairy market continues to consolidate

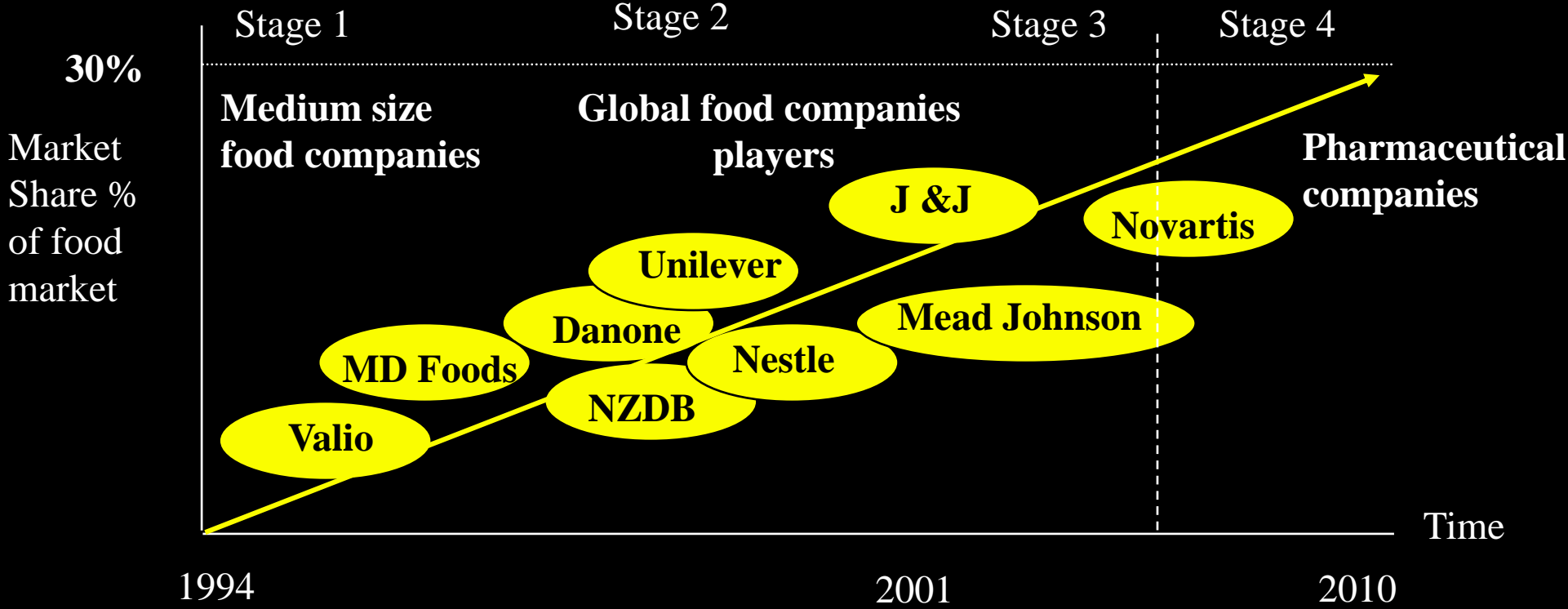
- Nestle acquisition of Borden's Klim
- Friesland Coberco Dairy Foods merger
- Formation of Dairy Farmers of America
- Suiza Foods (US) 1998 acquisitions US\$1 billion
- Dean Foods (US) 1998 US\$1.1 billion in acquisitions
- Parmalat acquisitions continue 1998 US\$ 625 million

Global Retailers

Recent global retailer activities continue to consolidate buying power for example...

- Tesco (UK) acquires Lotus Thailand and targeting Korea, Taiwan
- Carrefour (France) expanding in SEA and Latin America with 150 new stores by 2002
- Ahold (Dutch) active in 17 countries up 62% since 1994
- Auchan (France) active in 10 countries up 19% vs 94
- Dairy Farm (HK) focus on Asia post UK divestments

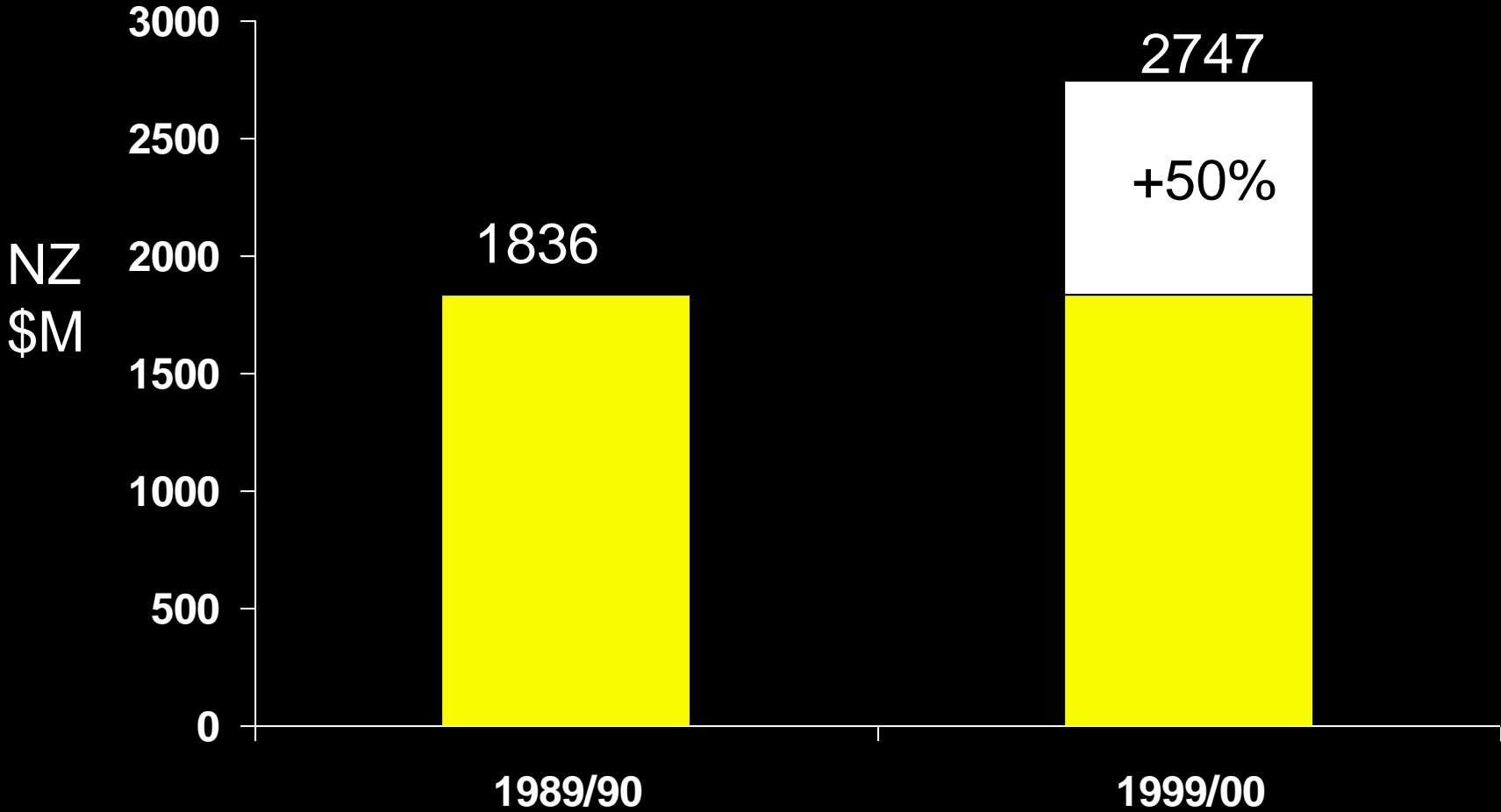
Functional Foods



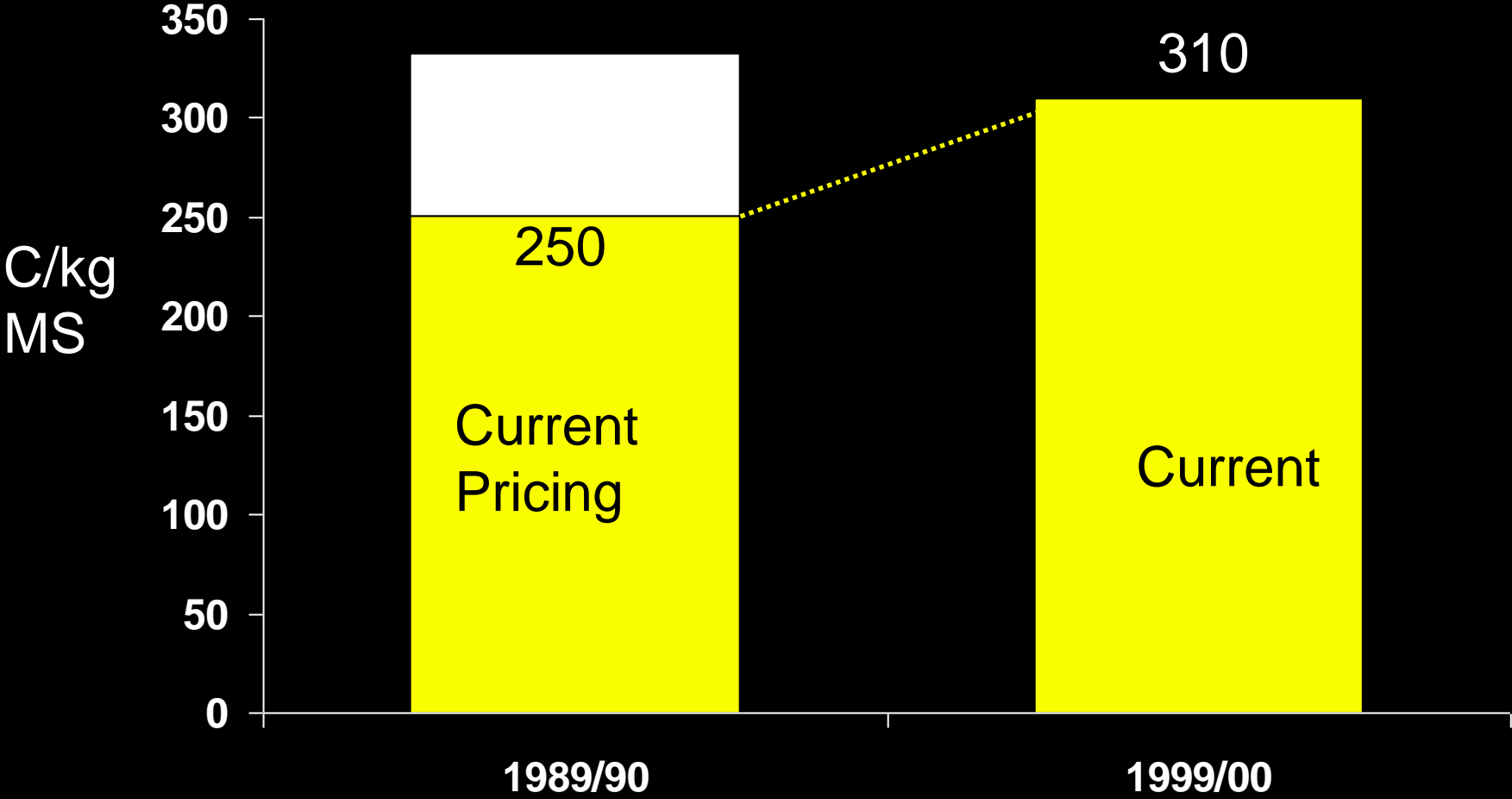
Entry of pharmaceutical players will drive functional foods to 30% of total European foods market

Growth to Date

Payment for Milk

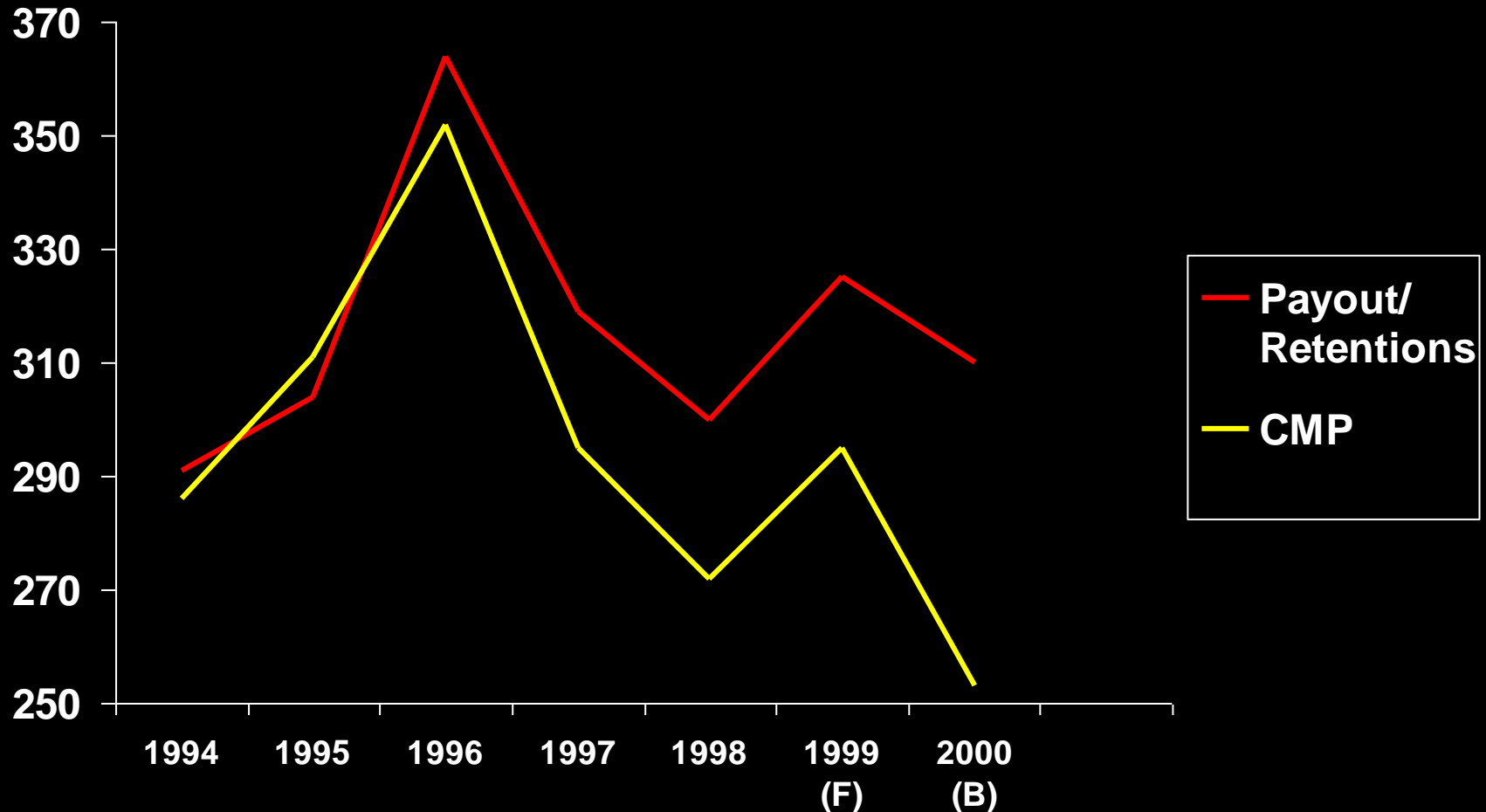


Payout



Under common assumptions B/E milk price around 60c higher 10 years later

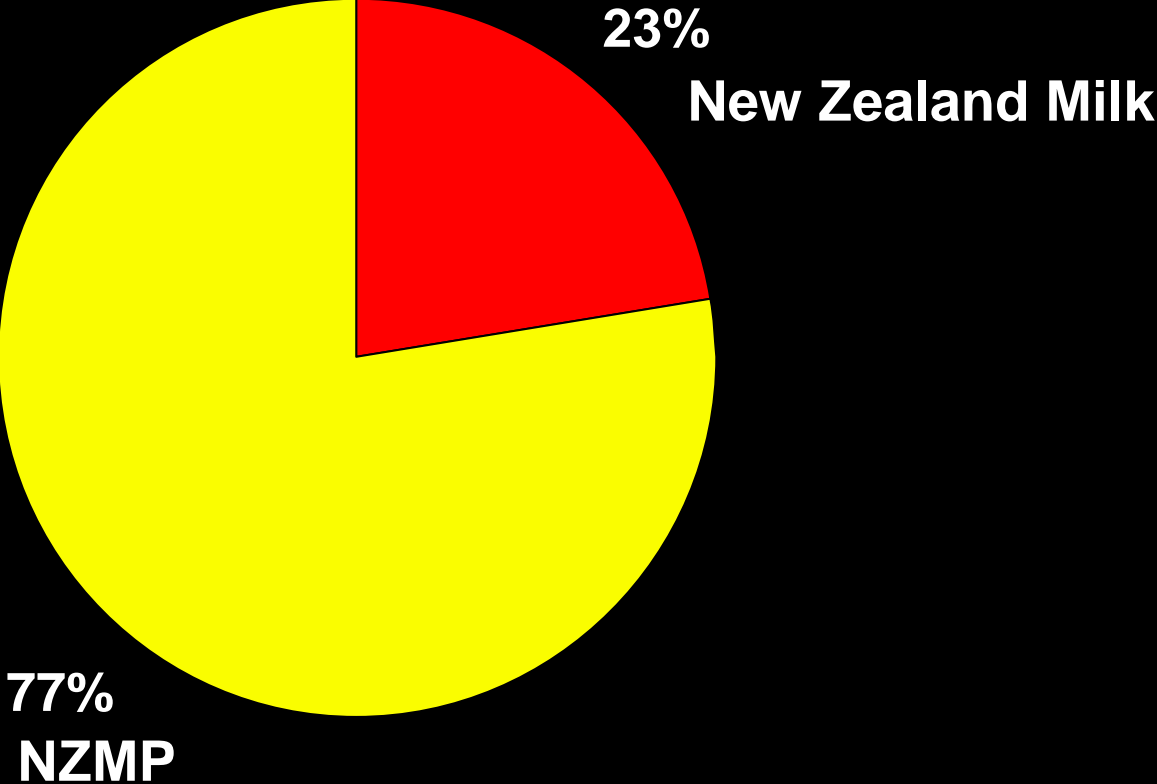
Estimated CMP/Payout Spread



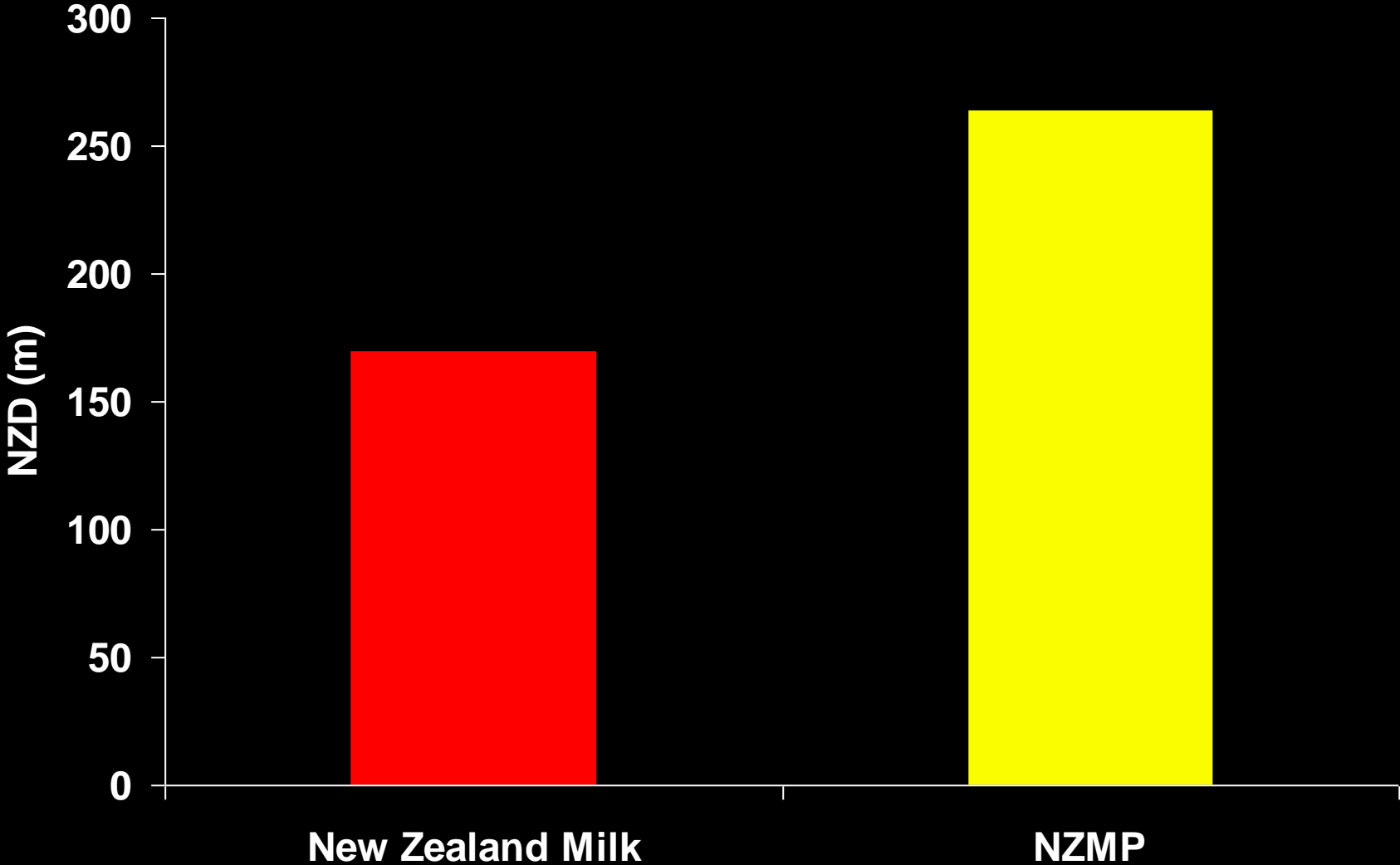
Note 1 CMP for 1994/1997 sourced from BCG Performance and Efficiency Audit

2 CMP for 1998-2000 sourced from Boards EBIT Reporting Systems

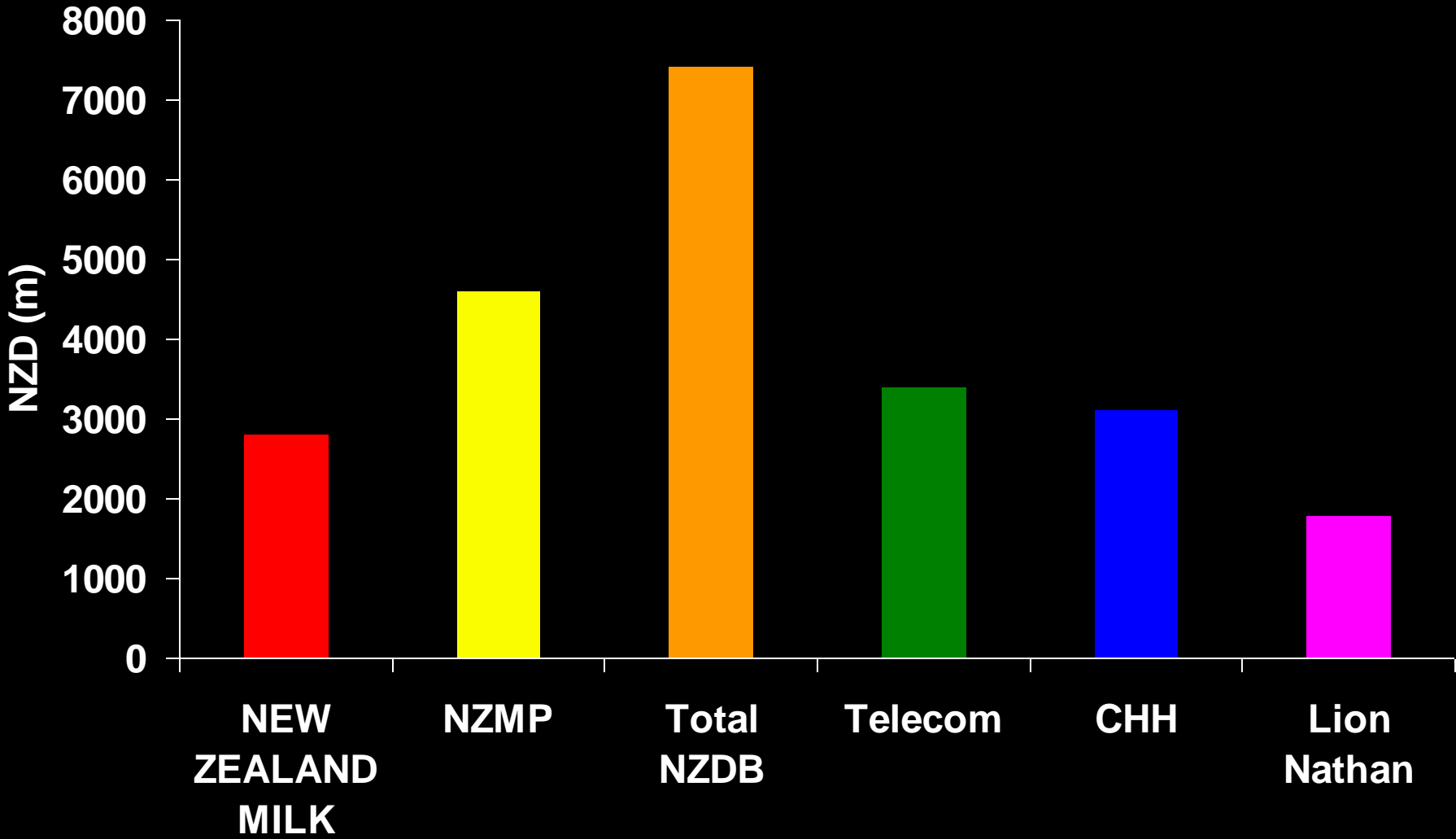
Business Unit Volume (NZ Milk only) - 1998/99



Business Unit EBIT 1998/99



Comparative Revenue 1998/99



STRATEGIC RESPONSE

Industry Strategic Plan

Warren Larsen

- **Key Messages**
- **Key Strategies**

Key Messages

To create the world's pre-eminent dairy business which builds and leverages truly distinctive capabilities to capture opportunities on a global stage

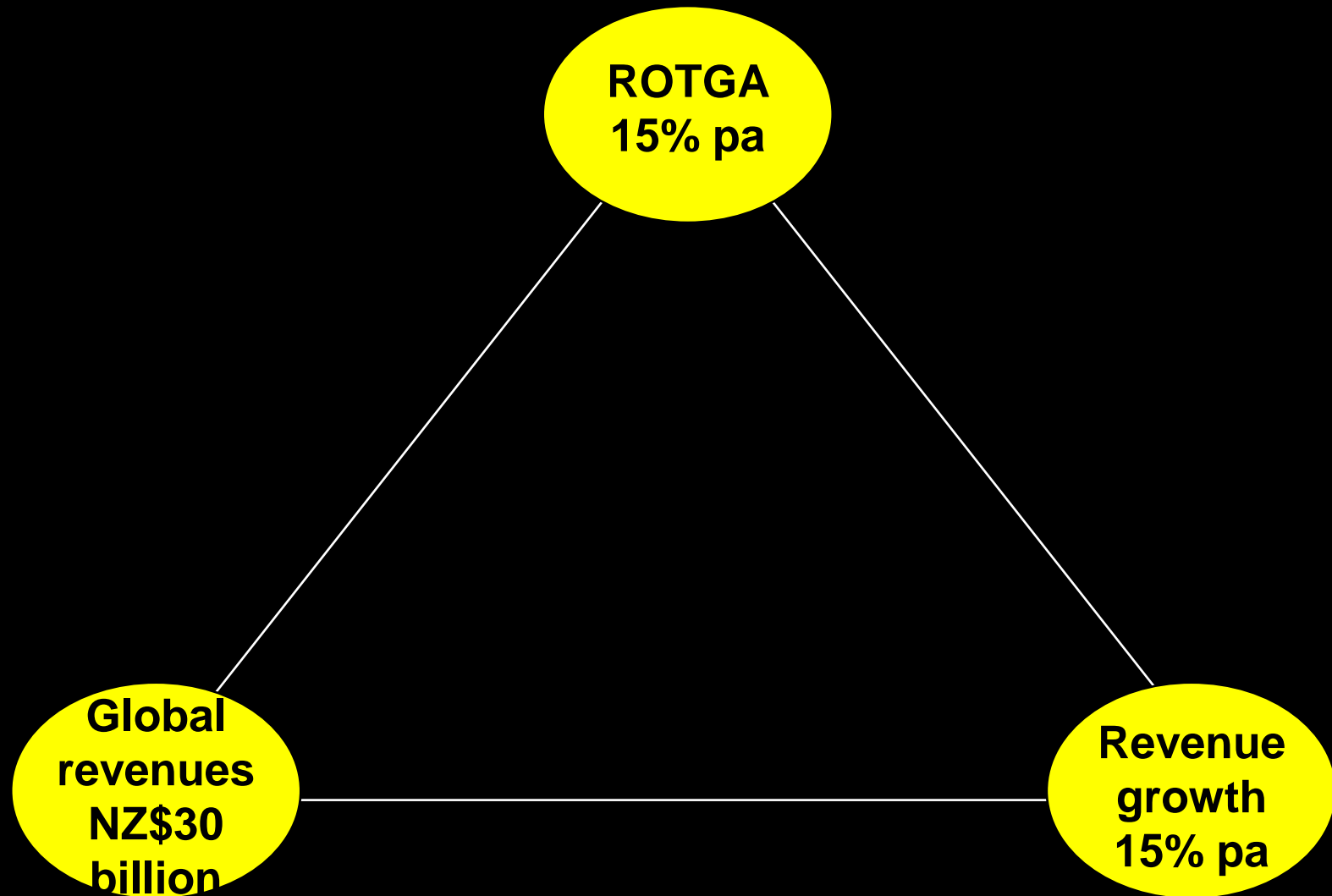
1 Defend and exploit our core position as the world's lowest-cost producer and seller of basic dairy products. This is our top priority

2 Take urgent steps to earn the right to grow outside the core

3 Pursue growth options outside the core (at the right time) by leveraging our unique skills to capture attractive opportunities

4 Consider options to tailor the structure of the NZDI to deliver the strategy

10 Year Financial Aspiration



Growth Horizons

Profit

Horizon 1

Extend and defend core businesses

- Defend and exploit core low cost position
- Earn the right to grow

Horizon 2

Build emerging businesses

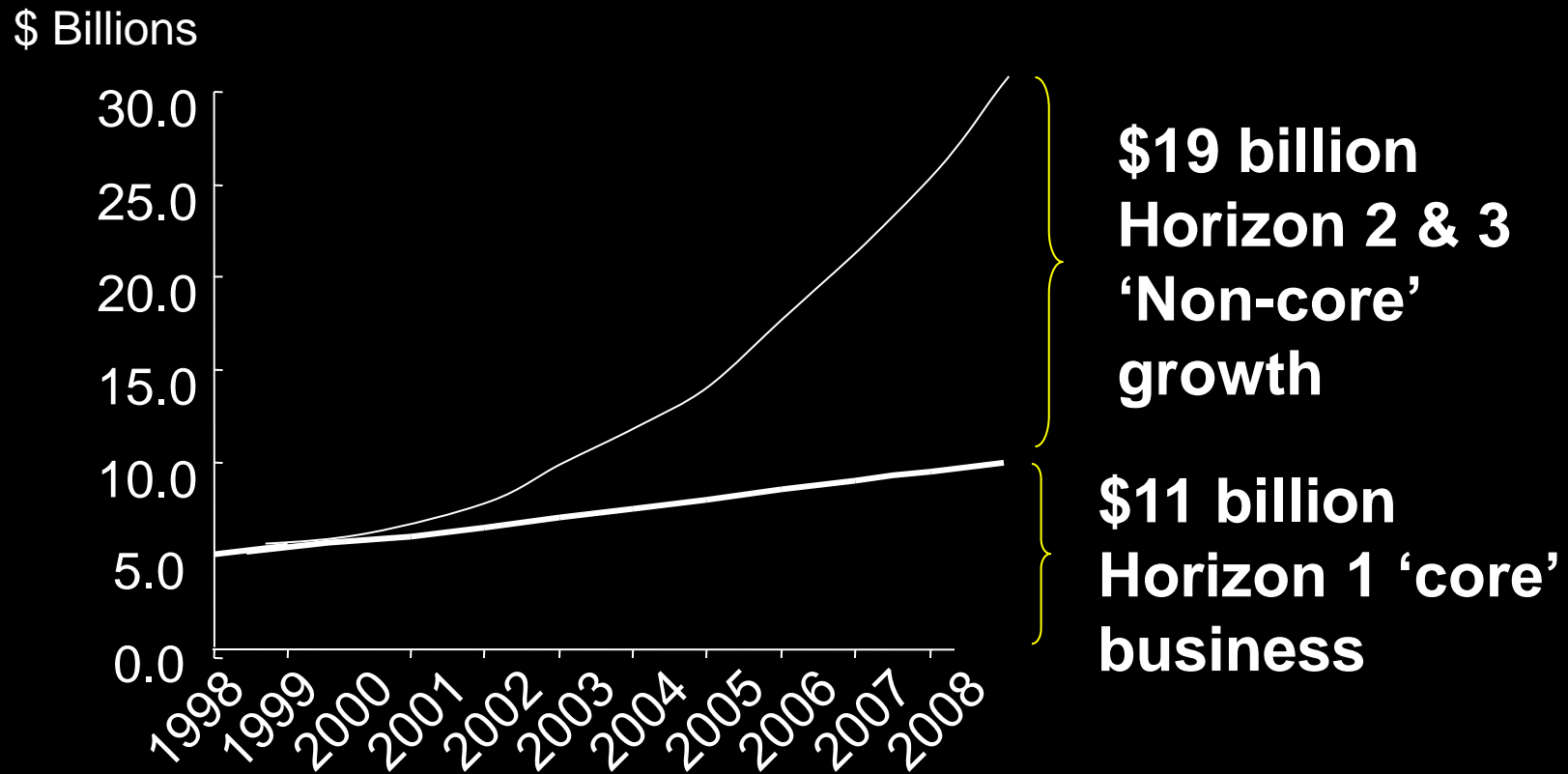
- Industry Milks strategy
- 'Global slivers' in specialised ingredients
- Leverage our ingredients network beyond NZ Dairy

Horizon 3
Create viable options

- Industry biotechnology agenda
- Risk management services

Time

Industry Strategic Plan Revenue Growth 1998 - 2008



Industry Structure

Tim Gibson

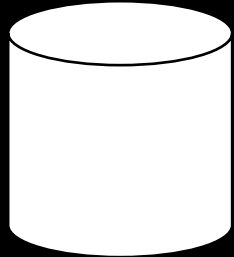
- **Current Structure Issues**
 - **Co-operatives**
 - **Options Considered**
- **Recommended Option**

The Problem With the Current Design



Why Co-operatives in Dairy

Farmer



Milk Vat

Milk

- Un-pasteurised
- Perishable
- Worthless after 48 hours

Processing Company

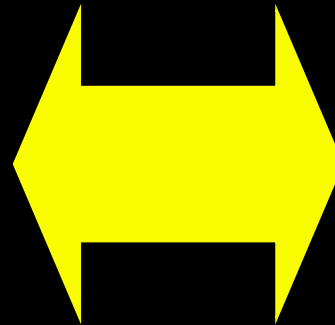


Factory

- \$100-150m
- Worth scrap without milk

Farmers

- Require a secure outlet for milk
- Require a fair price
- Have little choice today
- Have highly seasonal supply



Processor

- Requires milk to recover capital
- Want to receive it on a fair price
- Highly seasonal supply

International Co-operatives

- **Co-operative Structures are used around the world to overcome bargaining problems in Dairying**

| <u>Co-operative</u> | <u>US\$ Bn (Revenue, 1996)</u> |
|--------------------------|--------------------------------|
| Dairy Farmers of America | 7.5 |
| Friesland Dairy Foods | 5.5 |
| Campina Melkunie | 3.8 |
| MD Foods | 3.6 |
| Land O' Lakes | 3.49 |
| MergeCo | 4.8* |

*Estimate

Four Capital/ Ownership Design Choices



Capital/Ownership
Design Choices

External equity



Internal equity

Corporate governance structure



Co-operative governance structure

Ownership linked to supply



Ownership delinked from supply

Differentiated farmer payouts across NZ



Uniform farmer payouts across NZ

Four Organisation Design Choices



Organisation
Design
Choices

Multiple marketers



Single Marketer

Multiple
manufacturers



Single manufacturer

Vertically aligned



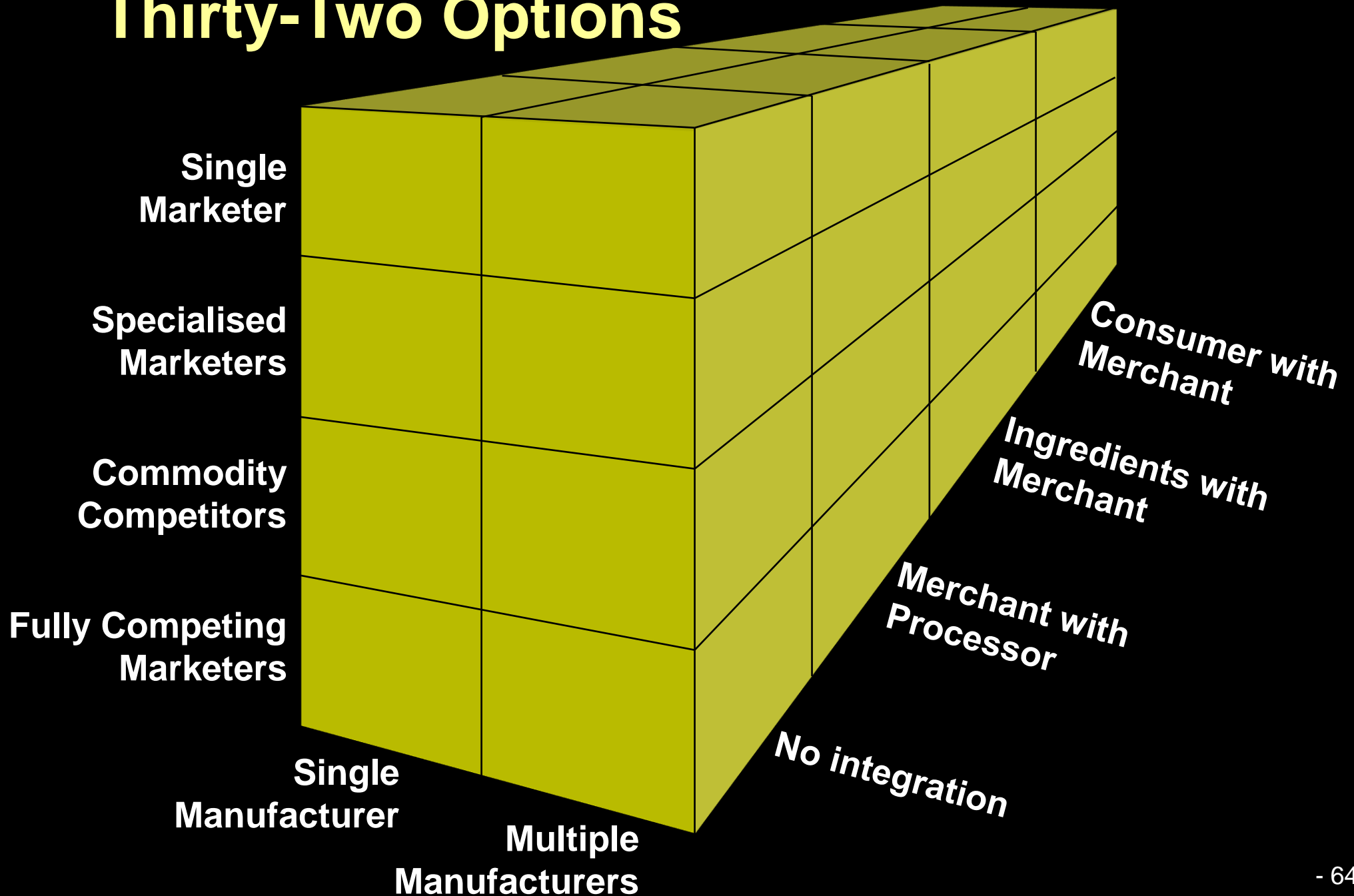
Horizontally aligned

Atomised
organisation

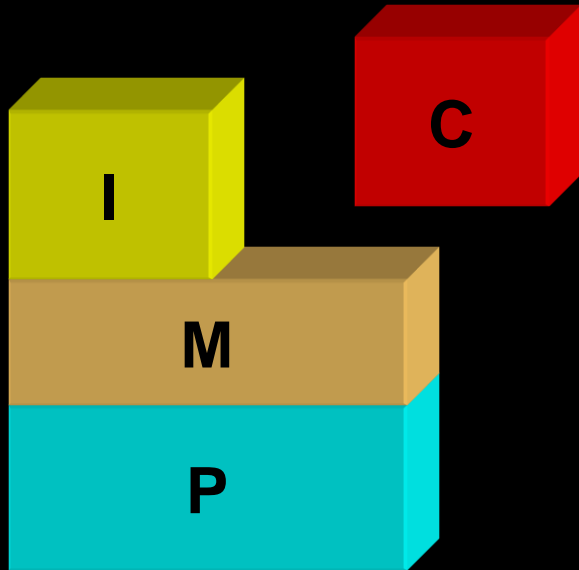


Centralised
organisation

Thirty-Two Options



Preferred Option



Single company for processing, merchandising and ingredients. Consumer separate subsidiary

Key Issues for the Commerce Commission

- **Fair Value**
- **Governance**
- **Local Market Competition**

Fair Value



Tradability

Share

Supply Link

Eligibility

A

80-120%

Amongst Farmers

Q

no linkage

Amongst Farmers

Governance

Shareholders' Council (30-100)

- Elected using ward system

Board of Directors (9-11)

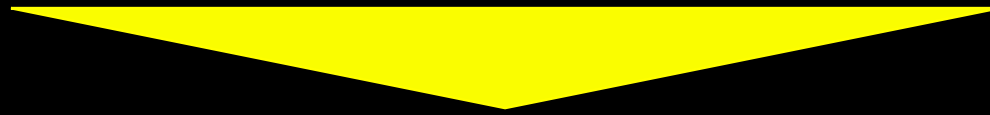
- Farmer Directors nominated by Shareholders and/or Shareholders' Council
- Independent Directors nominated by Board

2-3 Independents

7-8 Farmer Directors

DivestCo

Issue: Dominance of Domestic Dairy Market



Solution: Establish Independent Company by Divestment

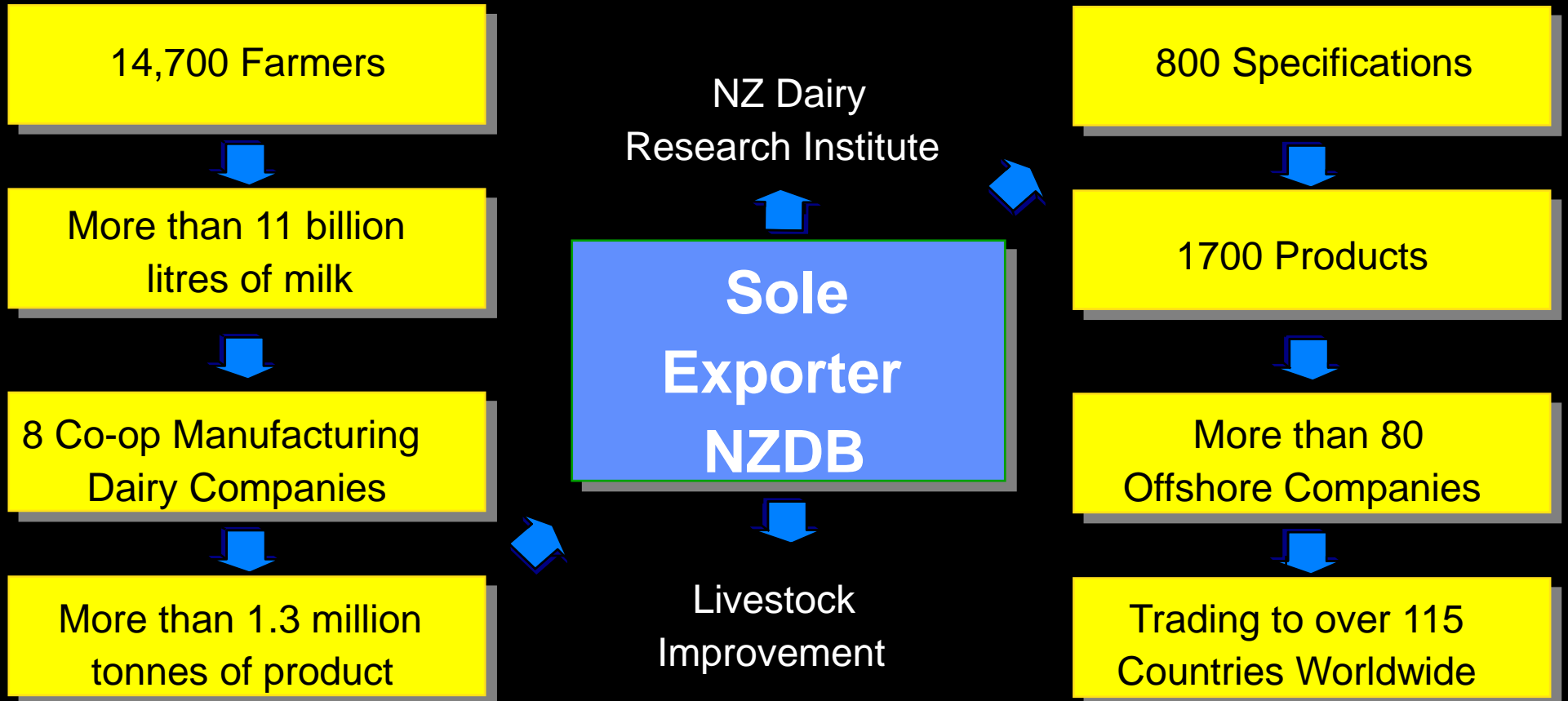
- **40% Market share in all key segments**
- **Arms length, non-exclusive milk supply contract and established brands**
- **Full manufacturing & marketing facilities**

Interface with dairy companies

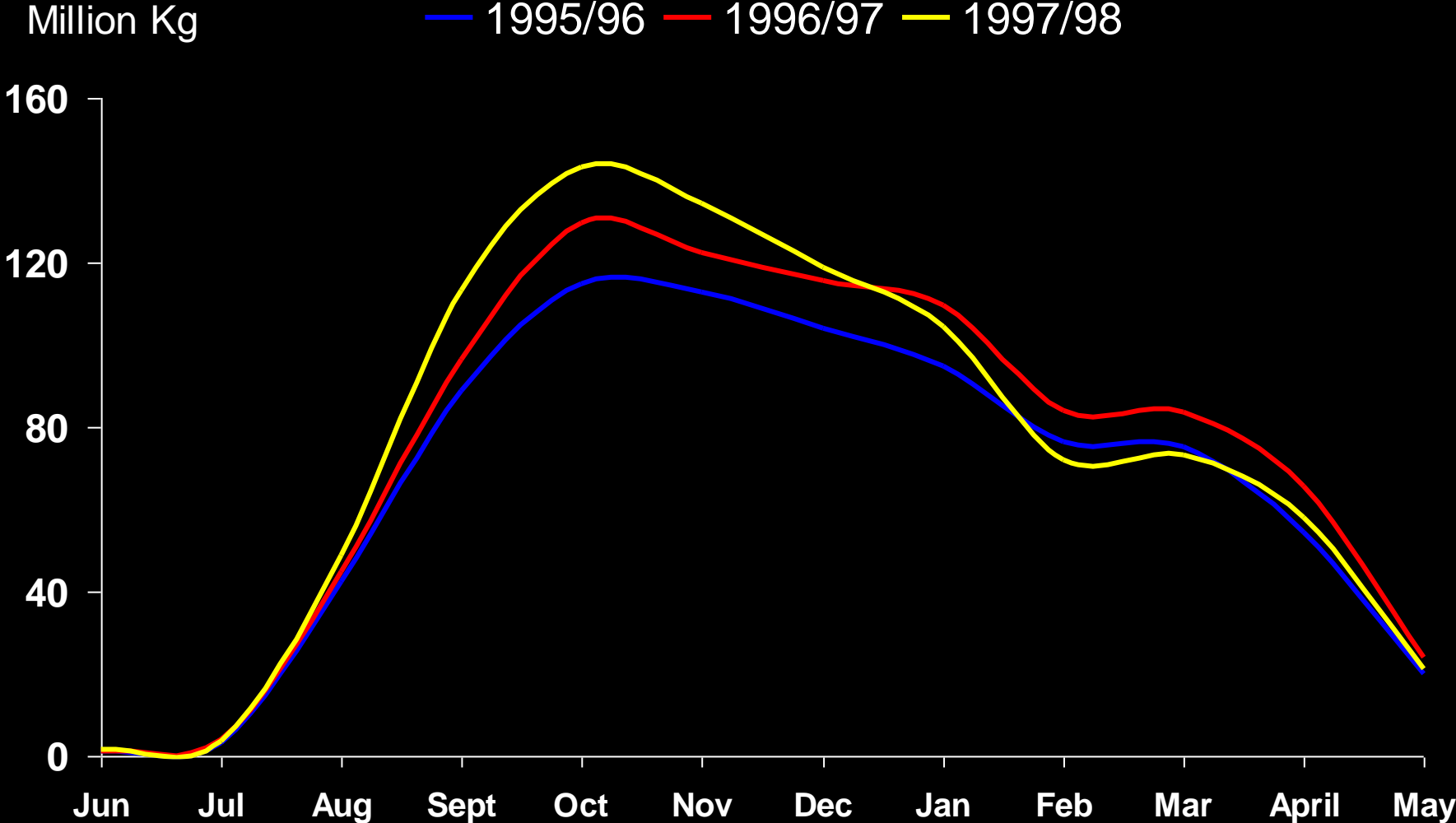
David Pilkington

- NZDI
 - Milk Supply
- Payment Process
 - Product Mix
- Interface Inefficiencies
 - Governance

New Zealand Dairy Industry



NZ Seasonal Milksolids Supply



Product Acquisition Process

- **NZDB purchases all export product from dairy companies on the 20th of month following manufacture**
- **NZDB manages inland transport, storage, ocean freight and export documentation**
- **Basis for payment to dairy companies has just been reviewed (BDP - Business Development Project)**

Payment Process

- **Prior to BDP companies were paid:**
 - **a single pooled milk price (NZDB Base Price)**
 - **Modelled standard manufacturing costs**
 - **Capital cost or return on capital payment**
 - **Grade penalties or premiums**
 - **Differential payments to influence preferred product**

Payment Process

- **Dairy Companies paid to farmers:**
 - NZDB base price, plus
 - Dairy company margin
- **Farmers judged NZDB performance through the NZDB base and dairy companies the margin**
- **Dairy company executives focused on maximising their margin versus others**

Payment Process

- **BDP introduced Commercial Pricing Model. As a result dairy companies will be paid:**
 - **Commodity product price**
 - **Additional incremental manufacturing costs for non standard products**
 - **For speciality products a share of the NVA (Profit)**
 - **A distribution of NZDB margin over commodity**

Payment Process

- **Changes were introduced to:**
 - **more closely reflect commercial reality into the payment system, and;**
 - **to allow farmers to more transparently judge the performance of the NZDB**

Product Mix Process

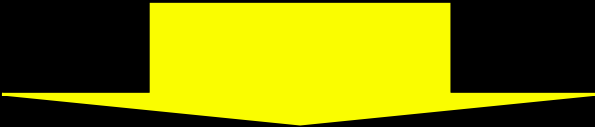
- **NZDB collates market demand information and advises commodity price data to dairy companies**
- **Dairy Companies decide their preferred mix of products to NZDB**
- **Iterative process required to fine tune mix to match market demand**

Interface Inefficiencies

- **Individual dairy companies make their own product mix decisions based on their analysis**
- **Several iterative steps needed to match combined result to market demand**
- **Allocation of new products to plants debated widely**
- **Dairy companies are drawn into non productive equity debates**

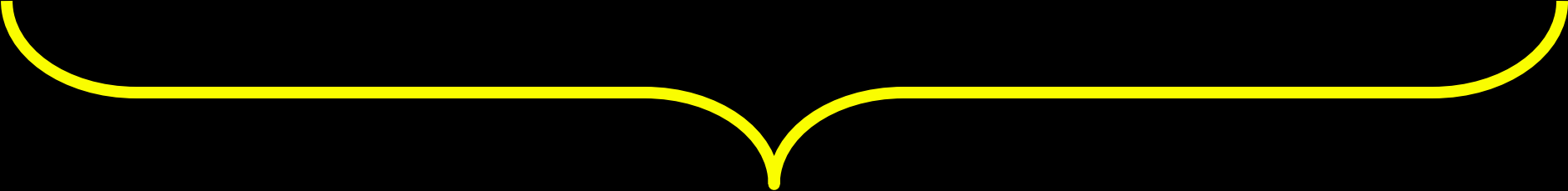
Current Ownership

14,700 Farmers



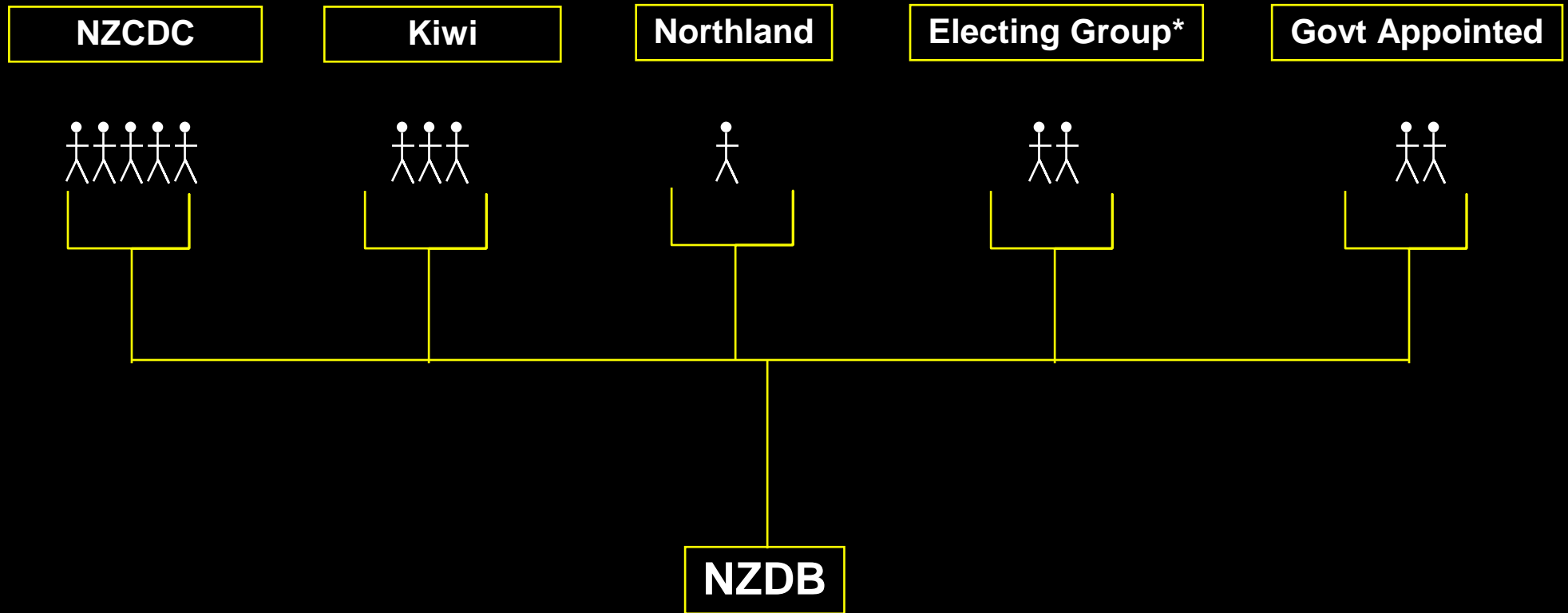
| | | | | | | | |
|-------|------|-----------|----------|-------|--------|----------|-------------|
| NZCDC | Kiwi | Northland | Westland | Tatua | Tasman | Kaikoura | Marlborough |
|-------|------|-----------|----------|-------|--------|----------|-------------|

| | | | | | | | |
|-------|-------|------|------|------|------|------|------|
| 58.2% | 27.3% | 8.7% | 2.7% | 0.8% | 1.5% | 0.3% | 0.5% |
|-------|-------|------|------|------|------|------|------|



New Zealand Dairy Board

Current NZDB Governance



* NZ Electing Group comprises Kaikoura, Marlborough, Tasman, Westland, Tatura

Wrap Up

John Storey

Summary

- **Complex Industry**
- **Huge benefit**
- **Industry committed to make it happen**
- **Co-operation assured**