Fonterra – A Long-Run Financial Assessment

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Introduction

One of the questions asked by the Government as part of its current review of the Dairy Industry Restructuring Act (DIRA) was: have the intended benefits of the 2001 industry restructure been realised? This Working Paper considers that question and is based on independent work TDB Advisory undertook for Westland Milk Products in the context of the current review of DIRA.

Analysis

The anticipated merger synergies from the establishment of Fonterra were $310 million per annum.[1] The sources of the benefits were anticipated to be as follows:

- annual cost savings in the order of $120 million as a consequence of the elimination of duplicated facilities and activities;
- annual revenue enhancements and productivity improvements in the order of $70 million as a consequence of enhanced economies of scale and scope as manufacturing activities were integrated with marketing and distribution functions; and
- additional increased earnings of $120 million per year as a consequence of being able to harness the synergies between different parts of the industry, provide fresh strategic impetus and broaden options to exploit new market technology and biotech opportunities.

We would expect to be able to measure the realisation of the merger synergies with reference to Fonterra's share price.

[1] "The Quigley report on dairy megamerger", 24 January 2001. Section 4.1 of the Quigley report refers to the "Business Case for Global Dairy Co Ltd: Executive Summary" which outlines the sources of the $310M in benefits that were claimed to be associated with the merger. http://www.scoop.co.nz/stories/BU0101/S00058/the-quigley-report-on-dairy-megamerger.htm

If it is assumed that Fonterra's 2001 opening share price of $3.85 incorporated the present value of all future merger synergies with certainty and if Fonterra had generated its required rate of return on its capital, we estimate that the current share price should be approximately $6.40.[2]

If it is assumed that the opening share price for Fonterra incorporated the risk adjusted present value of the future merger synergies, we estimate that the current share price should be in the range of around $7.60 to around $8.80.

Fonterra's current share price is around $4.90 and the 2018 fiscal year end (31 July) share price was $5.12. Since Fonterra's change in capital structure in 2012, its share price has averaged $6.10, with a range of $4.60 to $8.08.

In the lead up to the merger that created Fonterra, it was also projected that revenue would grow at an annual compound rate of 15 percent, largely as a consequence of the industry diversifying away from its commodity base.[3] The main growth in revenues was to come from 'non-core' activities – consumer products, specialised ingredients, biotechnology, 'new' products and risk-management services. The aspiration was for revenue to reach $30 billion within 10 years.

Over the last 17 years Fonterra has recorded annual compound growth in revenue of less than 2.5 percent. Revenue in 2011 (10 years after the merger) was $19.9 billion and in the latest year was $20.4 billion.

Dividend distributions to shareholders have been volatile and have not exhibited any clear growth trend through time. The lowest distribution has been 7c/kgMS and the highest has been 59c/kgMS. On average, the annual dividend has been 29c/kgMS, the same as the 2001 dividend, and annual dividends over the last three years have averaged 30c/kgMS, again indicating no sustained earnings growth in the non-commodity business.

Since its formation, Fonterra's normalised earnings before tax, depreciation and amortisation (EBITDA) has increased by 0.6 percent year-on-year.[4]

Overall, we conclude that there is little evidence that Fonterra has delivered the anticipated benefits to its shareholders. We assess that if Fonterra had delivered the benefits that were claimed at the time of the merger, its share price should now be around $7.60 to $8.80, compared with its current share price of below $5.00. Revenue growth has been well below expectations and the much-vaunted growth in value added products has not eventuated.

By way of caveat, it should be noted that Fonterra, like most companies, has been subject to some adverse and some positive shocks over the period that have affected its financial performance. It also should be noted that Fonterra has provided its farmer suppliers with a loan support package when the milk price was low over 2014 and 2015, although this is little recompense to outside investors.

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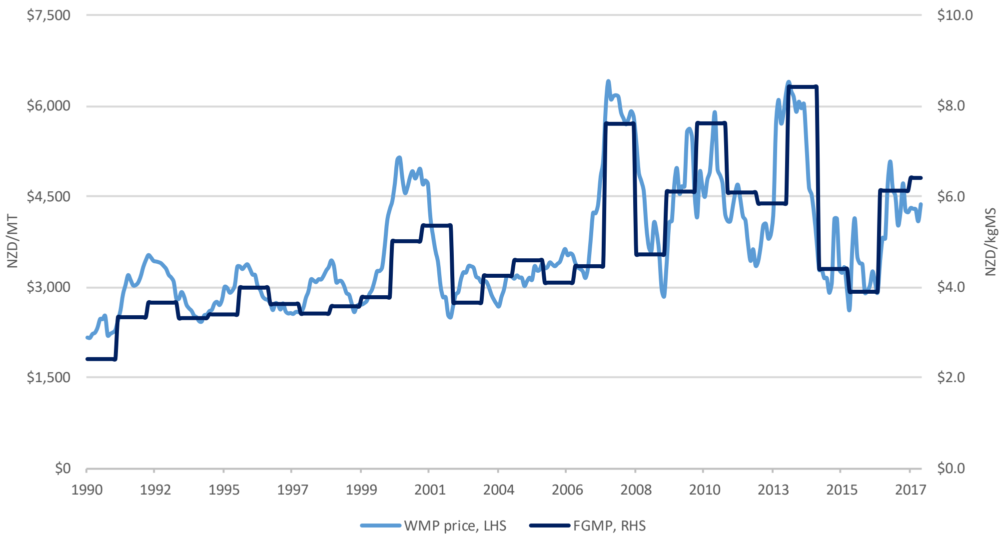
[2] For this calculation we assume an average cost of equity for Fonterra of 9 percent, an average dividend ratio of 70 percent, and incorporate all the new equity associated with increased production. Refer to the Appendix for details.

[3] New Zealand Dairy Board, *Industry Presentation to Select Committee*, 1999, pp 55-56. http://www.tonybaldwin.co.nz/mainpages/publications/publicationsdairy.htm

[4] ANZ Research, Agri Focus – we have lift off, June 2018, p.24.

We do not think that it can be argued that the anticipated benefits of the merger have been passed through to shareholders via the farm gate milk price (FGMP). The FGMP reflects the milk price as set by international commodity markets (refer Figure 1 below) and is receivable by any farmer supplier. A number of independent processors are paying slightly more than the FGMP on average to their suppliers for their milk and are still earning more than their required rate of return.[5]

Figure 1: Timeline of FGMP and commodity prices



While DIRA imposed some constraints on Fonterra to counter its government-sanctioned market dominant position, we do not think that it can be argued that the costs imposed on Fonterra by DIRA have been excessive. Historically, the contestability provision that has received the most attention by Fonterra has been the raw-milk supply provision. We estimate that the opportunity cost to Fonterra of having to sell raw milk to independent processors at the FGMP has been approximately $25-$30 million per annum. More recently, concerns have been raised about the open-entry requirements on Fonterra, but we are not aware of any evidence that this requirement has imposed a material additional cost burden on the company.

Options going forward

Overall, Fonterra's long-run financial performance has not been satisfactory and has been well below the level projected at the time of the mega-merger. Looking ahead, the question is: how can the situation be improved? First and foremost is shareholders recognising the limitations of the status quo. We think that recognition is starting to emerge.

Options that could be considered by Fonterra's farmer shareholders include:

[5] Refer TDB Advisory's NZ Dairy Companies Review, April 2018. https://www.tdb.co.nz/wp-content/uploads/2018/05/TDB-Dairy-Companies-Review-2018-1.pdf

- reviewing the Trading Amongst Farmer scheme. This arrangement is complicated and opaque, is not well regarded in capital markets and has inherent conflicts between shareholders and suppliers;
- considering a more fundamental restructuring of Fonterra, such as separating the ingredients business from the consumer and food-service segments along the lines that were proposed in 2007. This would require the branded business to compete for farmers' milk in a more transparent way, would not compel farmers to invest in risky offshore investments and would allow the business access to outside capital to fund its growth;
- adopting a "mixed-ownership model"[6] where Fonterra's ordinary shares are publicly listed, but the majority of the shares and hence control continues to rest with farmer shareholders. The majority of shares could, for example, be held in a separate vehicle that can only be owned by farmer-shareholders; and
- modifying the current governance appointment process which gives the current Board influence over its own composition.

As more competition emerges for Fonterra at the farmgate, and subject to the interests of New Zealand consumers being adequately protected, the government could look to remove the regulatory obligations in the Dairy Industry Restructuring Act around Fonterra's Trading Amongst Farmers capital structure. These regulated obligations impede Fonterra's flexibility to make decisions around its capital structure and result in political as well as commercial considerations driving Fonterra's capital financing decisions.

Conclusions

Fonterra has, from a long-run financial perspective, fallen well short of expectations. The company's share price is well below where the price should be if Fonterra had delivered the merger benefits that were forecast at the time the company was formed by special legislation. Moreover, the much anticipated "move up the value chain" has not been achieved, with revenue growth falling well short of the targets that were set. It is encouraging that the company has announced an "everything on the table" review and the government is at the same time reviewing the legislation. In our view, a fundamental rethink is required if the company is to add value to its suppliers, its shareholders and the New Zealand economy.

[6] Along the lines of the central government's sell-down of 49% of its shares in Meridian, Mighty River Power and Genesis Energy in 2013 and 2014. A review by TDB Advisory of the Mixed Ownership Model experience can be found at https://www.tdb.co.nz/wp-content/uploads/2018/08/TDB-Mixed-Ownership-Review-Jul-18.pdf

Appendix: Calculation of Fonterra's capital value including and excluding assumed merger benefits

In 2001, the initial Fonterra share price was set at $3.85 and there were initially 1,110,153,888 shares on issue. This gave Fonterra an initial market capitalisation of $4.3b.

Added to this is the (then) present value of the estimated annual merger benefits ($310m per year or $223m after tax assuming a 28 percent tax rate). Assuming that the required return on equity is 9 percent (which is in-line with current market estimates of Fonterra's cost of equity and is likely historically prudent given the period over which we are estimating the change in capital value), the ($2001) present value of the annual merger benefits equates to $2.5b. The theoretical value of Fonterra's equity immediately post-merger was therefore $6.8B or $6.08 per share as at 31 July 2018.

That equity value is required to generate a return of 9 percent per annum. That return could either be via an annual dividend or it could be capital growth or some combination of both (Re*(1-Div)). We have assumed the dividend policy to be 70 percent (consistent with the mid-point of Fonterra's stated dividend policy).

After the 17 years (2001 to 2018) this results in a total expected equity value of $10.6b.

In addition, as milk supply increases, new shares are issued and new equity is raised. From annual filings, we know there have been just under 500m new shares issued and $2.7b of new equity raised – on average at $5.32 per share. For simplicity, we have assumed that the same number of shares have been issued for the same price each year.

The expected value of this new equity is now $3.6b.

The total expected value of equity is therefore $14.2b. If we divide the $14.2b by the number of shares currently on issue we get a theoretical share price of $8.81.

The calculations are detailed in the table below.

A target price of $6.39 is the result of all the merger synergies having been factored into the opening share price with certainty. That is an unlikely scenario.

A target price of $7.60 is the result of half of the merger synergies having been factored into the opening share price with a high level of certainty.

A target price of $8.81 is the result of none of the merger synergies having been factored into the opening share price.

Table 1: Theoretical share price calculation (as at 31 July 2018)

Original Fonterra shares on issue	1,110,153,888
Value per share	$3.85
Original Fonterra equity value	$4,274,092,469
Anticipated annual merger benefit (pre-tax)	$310,000,000
Anticipated annual merger benefit (after-tax)	$223,200,000
Cost of equity	9.0%
PV of anticipated annual benefits	$2,480,000,000
Theoretical merger equity value	$6,754,092,469
Theoretical merger equity value per share	$6.08
Average dividend rate	70%
Years since merger	17
Theoretical equity value now	$10,623,424,686
Theoretical value of those shares now	$9.57
Weighted average number of shares (as at 31 July 2018)	1,610,005,000
Total number of shares issued since the merger	499,851,112
Average number of new shares issued per year	29,403,007
2001 Subscribed Equity	$3,229,000,000
2018 Subscribed Equity	$5,887,000,000
New equity raised	$2,658,000,000
Average equity raised per year	$156,352,941
Average share issue price	$5.32
Theoretical current value of equity raised since the merger	$3,563,428,397
Theoretical total current equity value if merger gains were realised and 100% of the projected gains were priced into original share price	$10,286,093,159
Theoretical current value per share if merger gains were realised and 100% of the projected gains were priced into original share price	$6.39
Theoretical total current equity value if merger gains were realised and 50% of the projected gains were priced into original share price	$12,236,473,121
Theoretical current value per share if merger gains were realised and 50% of the projected gains were priced into original share price	$7.60
Theoretical total current equity value if merger gains were realised and were not priced into original share price	$14,186,853,082
Theoretical current value per share if merger gains were realised and were not priced into original share price	$8.81

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