FONTERRA:
CAPITAL ISSUES

Agrivision Group

www.tonybaldwin.co.nz

15 March 2007

Context

This presentation followed an address by Graham Stuart, Fonterra's Director, Strategy and Growth

Rather than present these slides, I engaged in a discussion with the Agrivision meeting. I referred to particular slides where relevant to the discussion

Fonterra’s view

“There are a few zealots like Tony Baldwin, who seem philosophically bent on sounding the death knell of co-operatives....

Graham Stuart – Taranaki Daily News, October 2004

It is a shame that supposed leaders like Graham resort to uninformed name-calling and old industry prejudices – instead of openly addressing the real issues

My approach

- I have *no* ideological views about cooperatives

  "[Cooperative forms are] not anomalies, but competitive institutions that form an integral part of a healthy market economy"

  Bengt Holmstrom, Prof of Economics at Massachusetts Institute of Technology

- Structure follows strategy. Some strategies can be best achieved by cooperatives

Key question

The key question is – does F’s current structure fit its claimed strategy?

The answer is almost certainly no.

What are you?

“ We are a dairy farmers' co-operative.

And we are a multinational marketing company.

And we are also an international capital investor”

Graham Stuart, 2002

Is this how *you* see Fonterra?

What are your goals for Fonterra?

- Maximise payout?
- Keep exclusive farmer control?
- Stay a co-op?

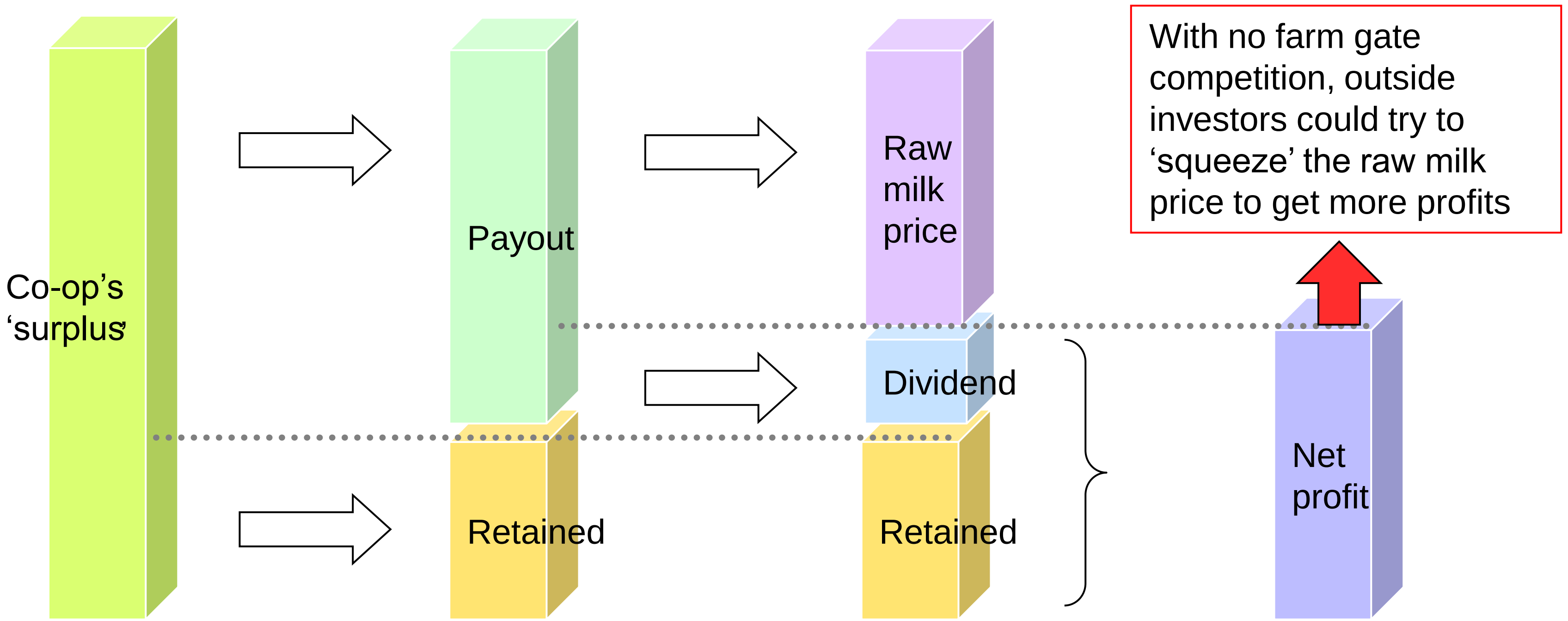
Why a co-op?

- But why a co-op? Why 100% control?
  - To guarantee milk pick up and processing, and
  - To guard against non-supplier shareholders ‘squeezing’ milk price to get more profits
- But Fonterra wants more capital than you can provide and a more stable balance sheet
- Serious proposal for outsider shareholders
- Need to find other ways of addressing the two concerns above

Key problem

Traditional producers co-ops do not normally work out a net profit. They simply split their ‘surplus’ into ‘payout’ and ‘retentions’

So the core issue comes down to separating ‘payout’ into ‘raw milk price’ and ‘dividend’ in order to work out ‘net profit’



Options

- Options to address this problem include:
  - Long term milk supply contracts – with guarantees of milk collection, and
  - Independent rules to set a milk price that outside shareholders can’t ‘squeeze’, or
  - Help create more farm-gate competition – so you get a real raw milk price

Co-op philosophy

"At the heart of the Cooperative Philosophy is the distribution of wealth between shareholders"

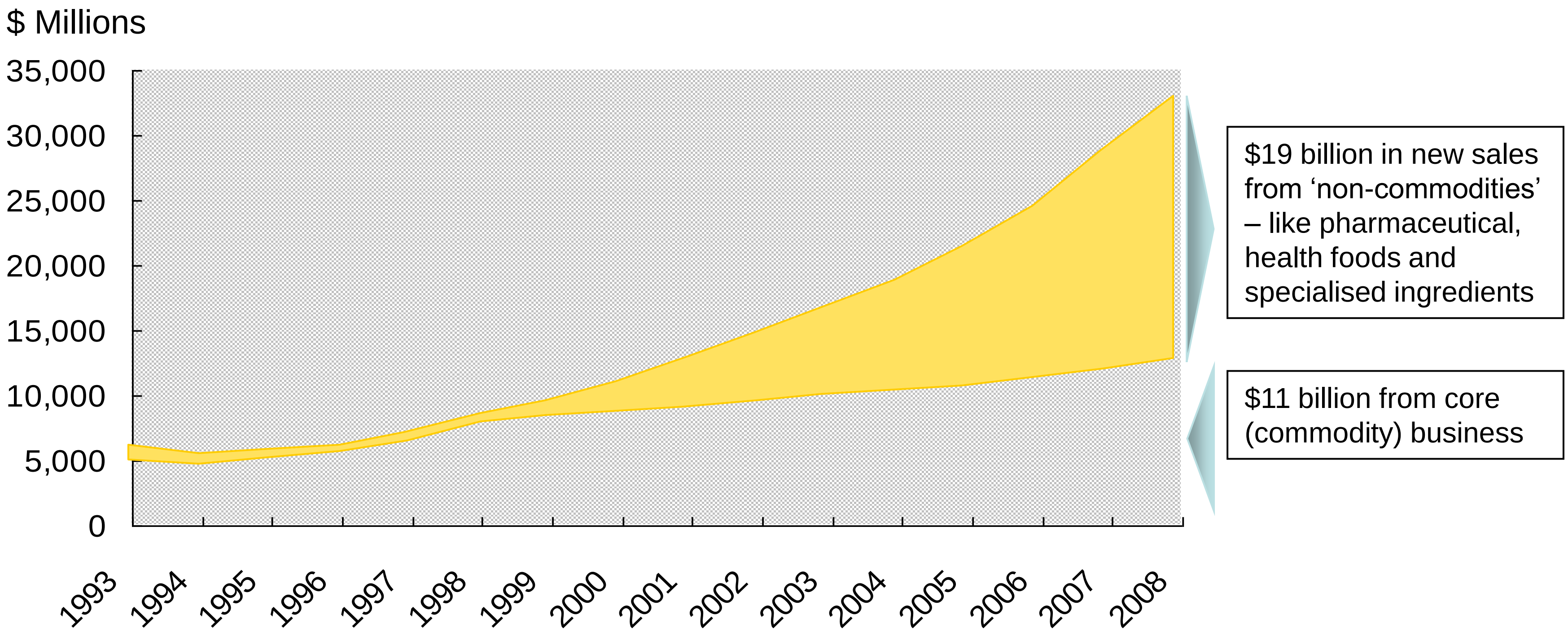
From Fonterra/shareholders' constitutional documents

But what matters more – growing wealth or keeping control?

Merger Vision

Over 10 years:

- Grow capital from $10b to $30b
- Grow revenues at 15% pa
- Deliver 15% pa return on gross assets



Source: Industry Leaders’ Presentation

Gains since 2001

- Integrated management and systems
- Some cost reductions
- Closer linkage between production and customers
- Better inventory management (decrease from 34% to 24% as % of annual sales volume)
- Improved supplier services
- Some gains in monitoring (‘fair value’ share and CMP processes)

Key capital problems

- Redemption risk
- Compulsory investment risk
- Insufficient shareholder funds
- Inefficient governance structure

Redemption risk

- Suppliers withdrawing at the same time
- Also involves loss of milk volumes required to cover fixed asset costs
- Also risk of 'regional cherry picking'

> "It is possible, even probable, that Fonterra will be faced with a declining share of the NZ milk supply, say 75-80% compared to 96% at present"
>
> Dr Alan Frampton, 2002

Compulsory investment

- NZ suppliers are forced to invest in non-NZ milk or non-processing activities

- But you are likely to get better risk adjusted returns over time from investing in a diversified portfolio of investments

Compulsory investment *(cont'd)*

- Fonterra obtains shareholder funds without having to compete in the capital market, so it has less incentive to use funds to return maximum yields over time

- Fonterra should pay a higher return to compensate for the higher risk, the compulsory nature of the investment and the lack of diversification in their portfolio

Insufficient equity

- “All over the world, value-adding businesses grow without having to frequently resort to capital markets for new equity....”.

- “Fonterra shareholders have already demonstrated the ability to commit the equity required to fund our impressive growth and there is no reason to suggest that cannot continue for the foreseeable future”.

Graham Stuart – Taranaki Daily News, October 2004

Insufficient equity *(cont'd)*

But not consistent with CEO's comments:

"While Fonterra can fund the immediate needs of the cornerstone activities and current options within our existing balance sheet, as the business evolves this may not always be the case…. ….Any inability to access sufficient equity could undermine our ability to realise the full potential of our value-added operations"

Andrew Ferrier, CEO, Fonterra – 10 June 04 – also repeated same concern in 2006

Insufficient equity *(cont'd)*

- Its only options at present are:
  - Retentions
  - Shares purchased to supply more milk, and
  - Inviting existing shareholders to subscribe more capital
- On a capped base of 13,000 suppliers, this not likely to generate sufficient capital to fund Fonterra's stated objectives

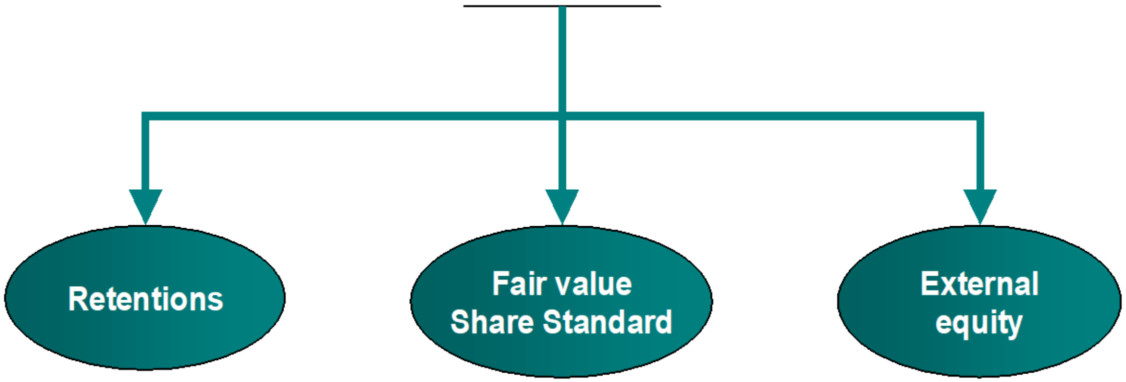
1999 Plan

Exhibit 4

CAPITAL REQUIREMENTS AND SOURCES

NZ$ Billions

Total capital required	12
Less debt capacity	8
Additional capital required	**4**



Source: McKinsey

2001 Plan

- Promar International commented in 2001 –

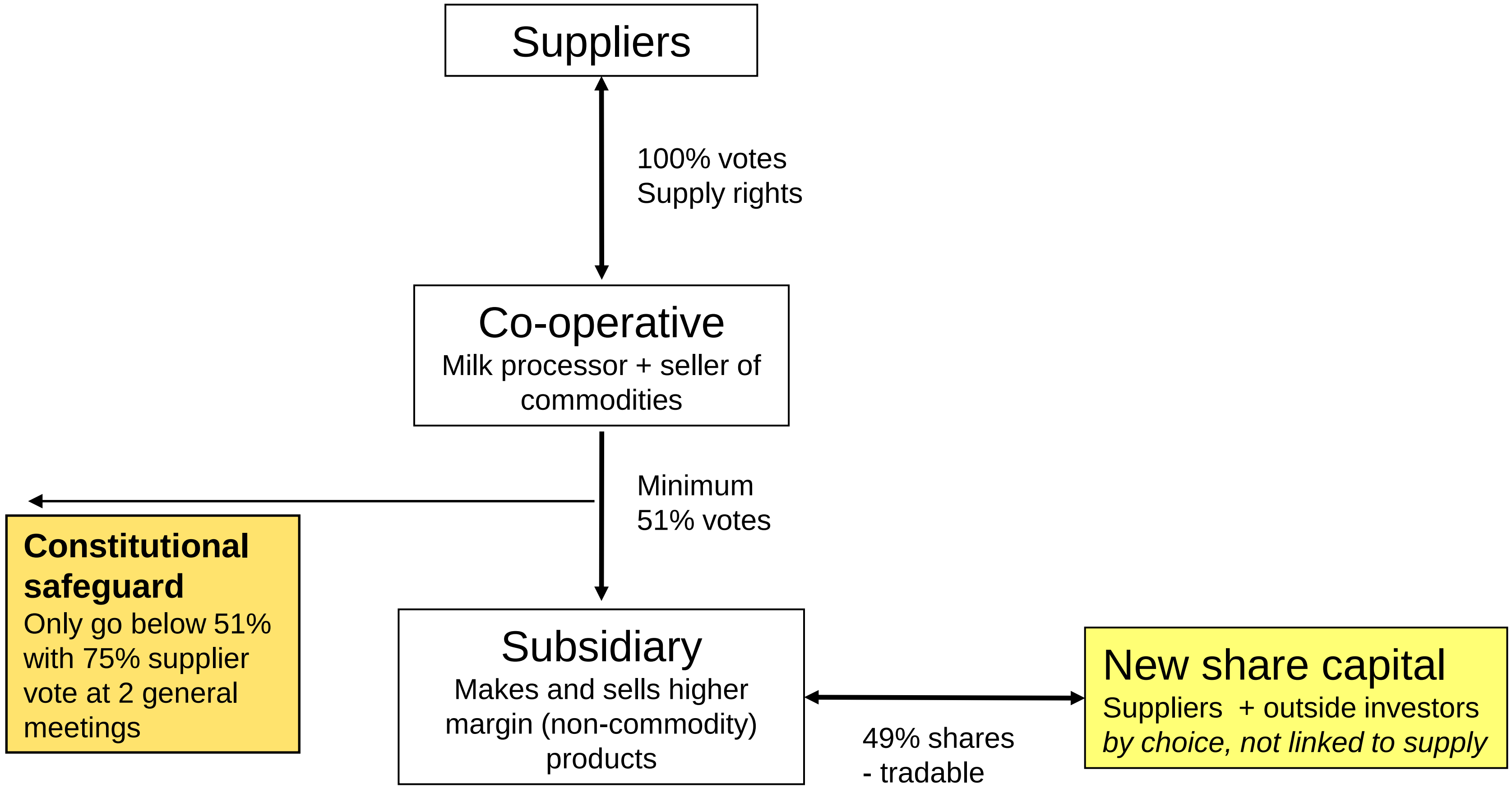
  “In the initial [1999] merger proposal, it was suggested that significant external investment would be needed for the organisation to meet its market objectives.”

  “Our understanding of the [2001] merger proposal [to form Fonterra] is that the capital requirements are similar…to undertake the development necessary, [Fonterra] could decide to bring in outside equity partners to complete the investment from supplier shareholders….”

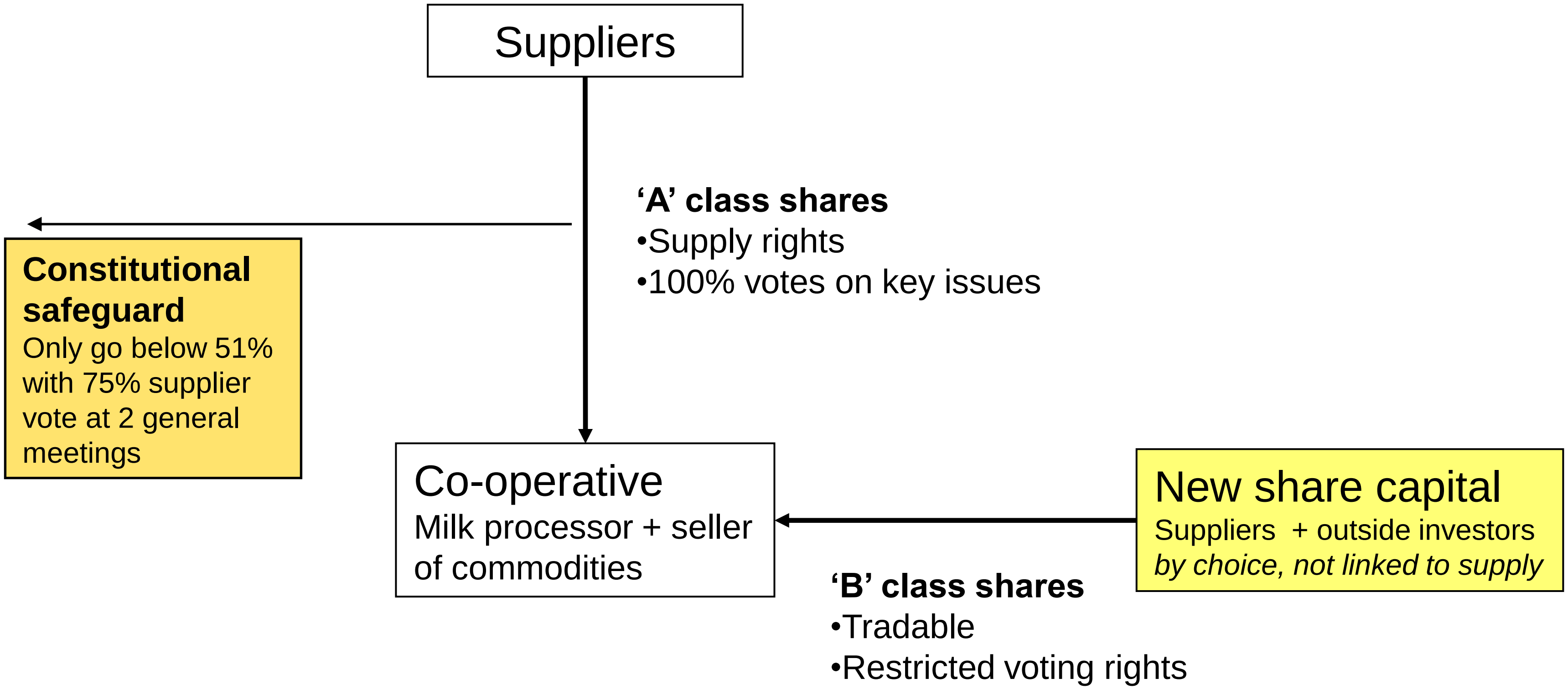
Options

- A separate company for the non-commodity business, controlled by Fonterra but with outside shareholders
- Non-supplier shareholders in the cooperative
- A public company controlled by the cooperative
- A public company with share in the cooperative, or
- A multi-national cooperative

Separate subsidiary



Co-op with two classes of share



An 'A' and 'B' share structure is used by Air NZ, Livestock Improvement Corporation and Friesland Coberco (Netherlands)

Public company controlled by co-op

Suppliers

100% votes
Supply rights

Co-operative
Milk processor

Minimum
51% votes

Constitutional safeguard
Only go below 51% with 75% supplier vote at 2 general meetings

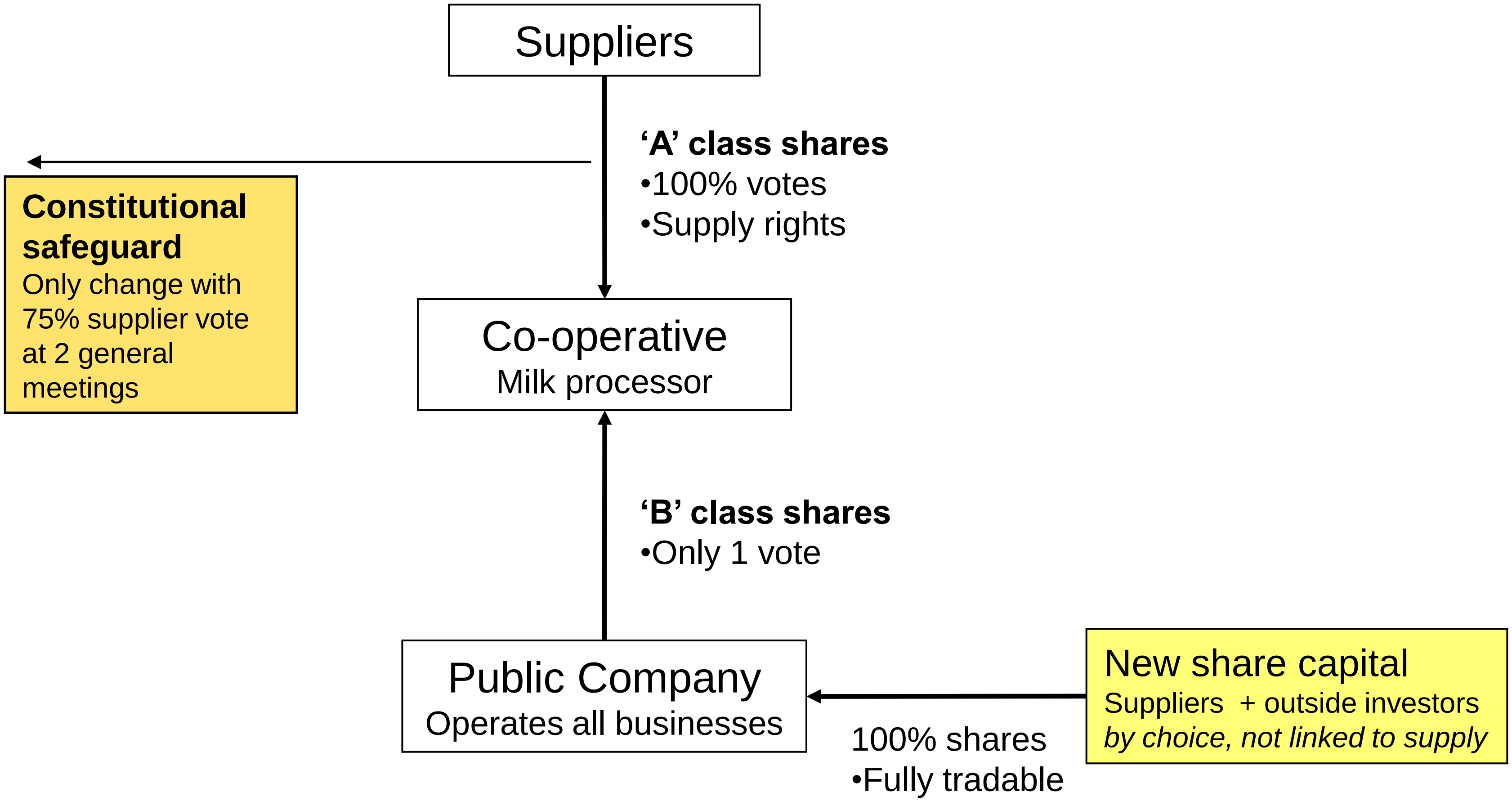
Public Company
Operates all businesses

New share capital
Suppliers + outside investors
by choice, not linked to supply

49% shares
•Fully tradable

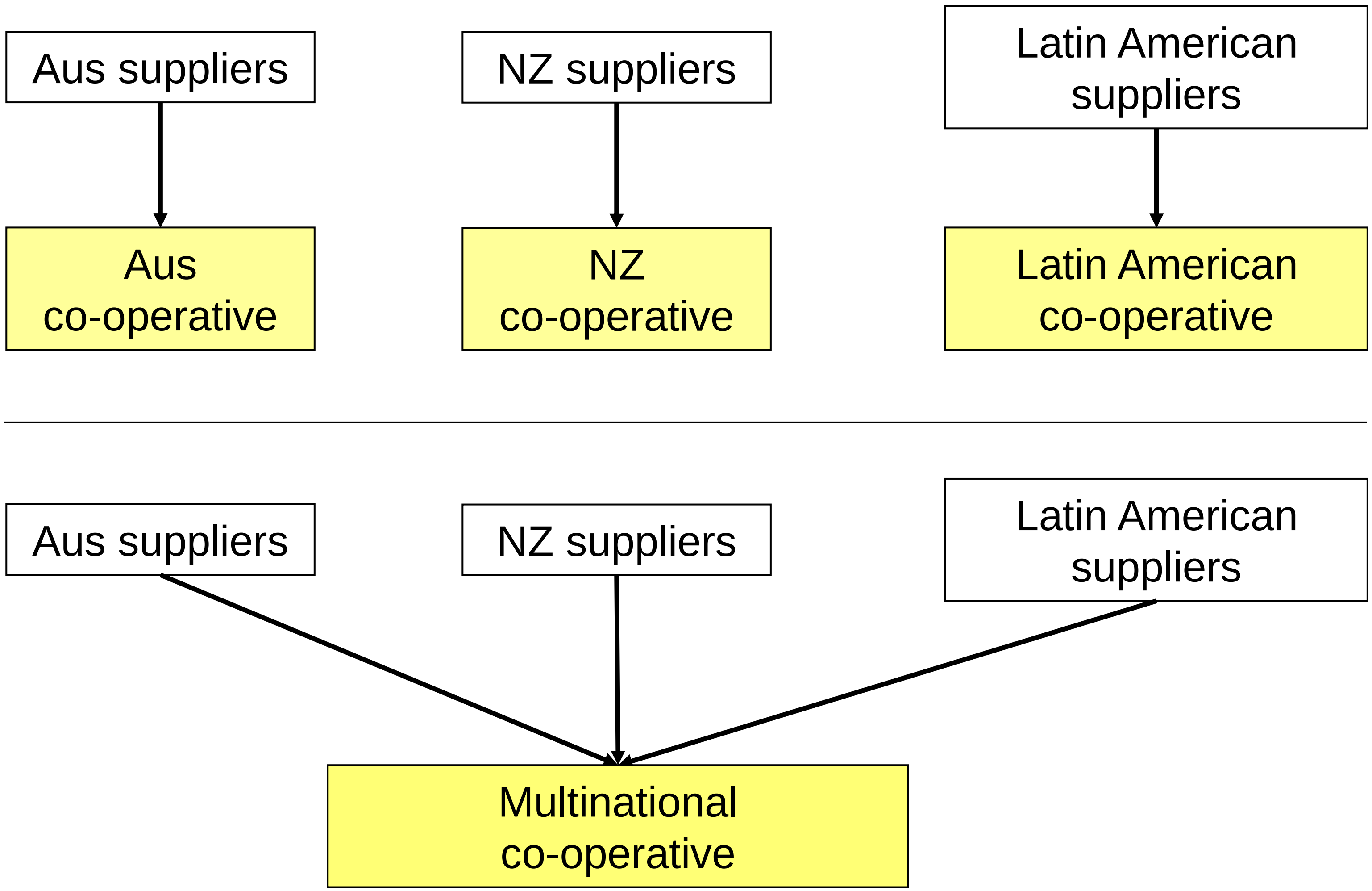
This structure was used by Kerry PLC and Glanbia PLC (Ireland)

Public company with shares in co-op



This structure was used by Golden Vale PLC (Ireland)

Multi-national co-operative



This structure is used by Arla (Denmark) and MD (Sweden)

Cooperative problems

- Widely recognised, even among cooperative advocates:
  - Limited access to share capital
  - Weak performance monitoring
  - Less efficient decision-making processes
  - Diverging expectations among suppliers
  - Multiple objectives – lack of strategic clarity
  - Lack of capital diversification by shareholders

Cross-roads in other countries too

"Co-operatives are at a cross-roads. The future of co-operatives depends on the ability of their leaders to convince members to structure themselves in order to compete on multi-commodity, value-added and global bases".

M G Lang (1995) – American Journal of Agricultural Economics

"[In Europe] the co-operative organisation form is in retreat due to problems of control and transferring market signals"

Torgenson, Reynolds + Gray (1999) – Journal of Cooperatives

Control

- The role of ownership is to gain the ability to influence decision-making via a direct governance
- It is *not* total ownership that counts, but control at the *margin*
- Ownership control is less of an issue if there is a market for entering and exiting
- Best for many interested parties (capital markets) to measure the pros and cons of a company's investment plans
- Total closed control (with no trading of shares) denies shareholders this key benefit

Farmers' challenge

- Too many people in the industry automatically revert to the 100 year old clichés that involving 'outside' investors will only lead to farmers becoming "marginalised" and "turn their children into peasants"
  [*Dairy Exporter,* July 1997, p 66; see also Nuffield Scholarship reports by Marise James and Catherine Bull]

- The real challenge for farmers now is to evaluate these issues with an open mind – to put the old clichés to one side.

- The idea that markets are in conflict with cooperation is a serious misconception

Value of Kerry shares

1974		1986		2004
100% of Kerry Co-op		51% of Kerry plc		31% of Kerry plc
€1.25 million	⇨	**€40 million**	⇨	**€1,007 million**

Value of members' investment increased significantly even though the co-op's control of Kerry decreased

Exclusive control vs. value

NZ farmers say no to any proposals unless –

- Suppliers keep total control
- No outsider investors take a share, and
- Benefits are shared equally among all suppliers

Result :

– you own 100% of $100 = **$100**

vs

– 50% of $1,000 = **$500**

Copy Kerry?

Denis Brosnan, Kerry’s highly successful CEO (retired):

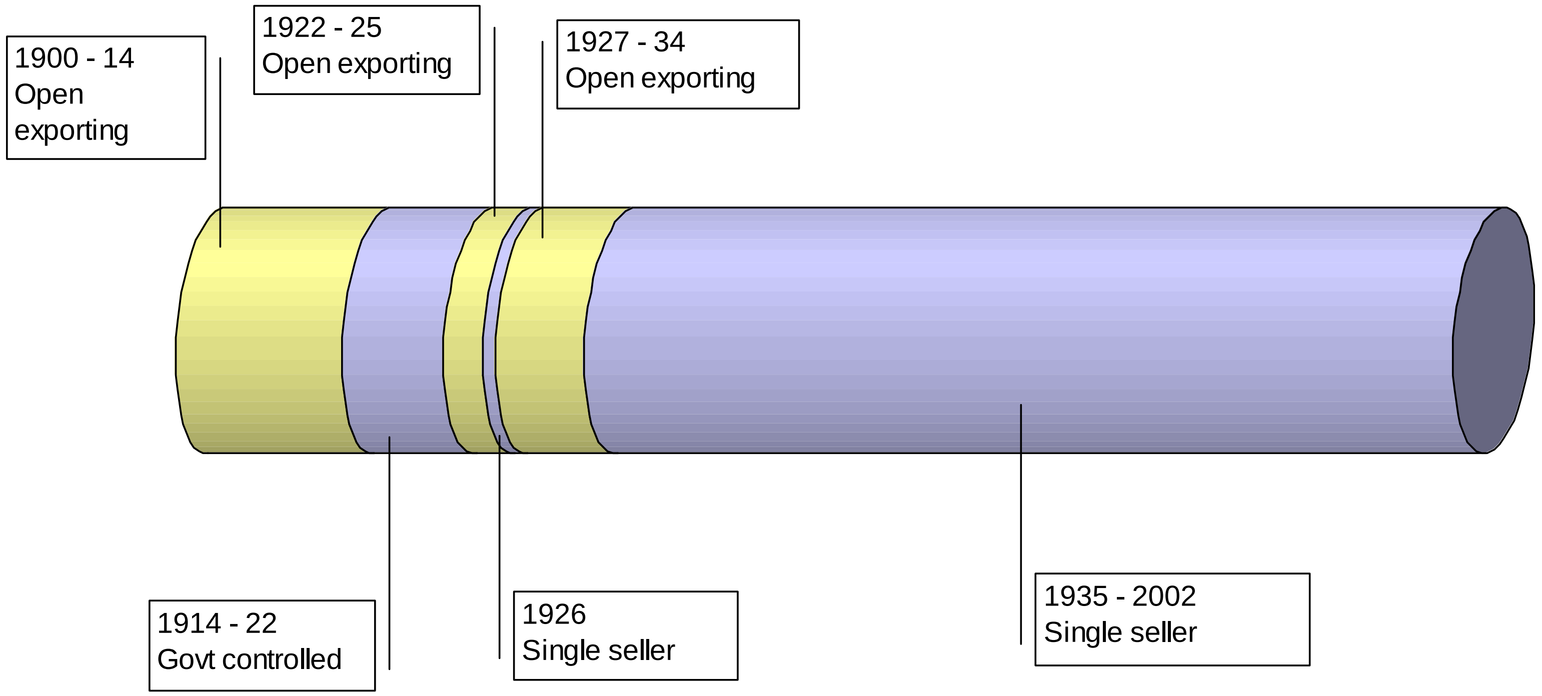
“If one ever wishes to follow the [public company] route, it will first be necessary to have a change in philosophy before changing the structure, not visa versa…”

Background slides

NZ industry removed competition

Over 100 years, the industry drove out competition in processing and exporting. It also drove out diversity of ideas, which any industry needs to realise its full potential. This strategy was based on two misplaced myths:

- That ‘outsiders’ will reduce suppliers’ wealth, and
- That a single exporter will deliver higher prices for commodities



Fear of ‘outsiders’

- “Unity among farmers emerged from their shared distrust of outsiders” *(David Yerex)*
- “Dairy farmers developed a suspicion of city and urban interests...were seeking more than a fair share of his hard-won livelihood” *(Arthur Ward)*
- These ‘outside’ interests included virtually everyone beyond the farm gate: “processors, quality controllers, wholesalers, distributors, merchants, advertising agents, bureaucrats, retailers, financiers and tax gatherers” *(David Yerex)*

Faith in cooperative

- “Dairy farmers came to believe - and it was an **article of faith** - that they secured more of the selling price of their produce by the cooperative method” *(Arthur Ward)*

- “After a slow start, the concept of the cooperative dairy company spread **like a faith** – an extension of the small-holder’s desire for as tight a mastery as possible over his destiny” *(Gordon McLaughlan)*

- The culture and values of these pioneering days remain a strong influence in the modern era *(Ward, McLaughlan and Yerex)*

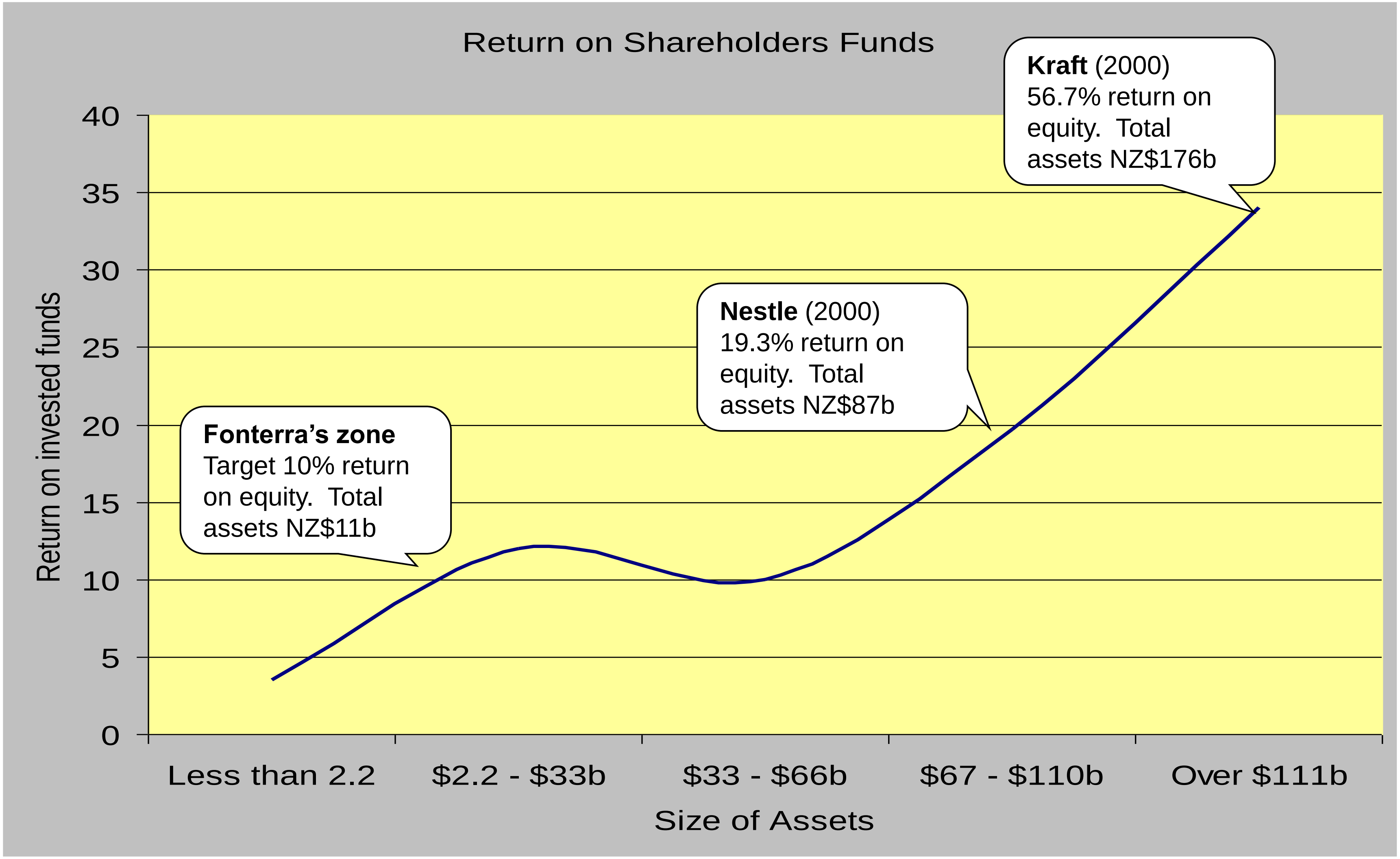
‘Critical mass’

Promar International’s 2001 view on the minimum scale for global food companies, with significant dairy in their core activities:

	Minimum Size	Fonterra
Total Assets	$67 billion	$11 billion
Employees	180,000	20,000
Revenue	$111 billion	$13 billion

Source: Promar International

Returns relative to scale



Source: Promar International

No market power

- In basic commodities, Fonterra is ‘price taker’
- Except for a few narrow quota markets, Fonterra has *no* significant ability to raise world commodity prices
- Fonterra argues that its international supply chain management and handling of third party milk products helps smooth some potential short-term price fluctuations
- However it is clear that Fonterra cannot fundamentally change commodity prices

World dairy rankings (2006)

2003	2006	Company		Country	2006 dairy sales (Euros)
1	1	Nestle	*Private*	Swiss	14.3
2	2	Dean Foods	*Private*	USA	7.2
9	3	Lactalis	*Private*	France	7.2
5	4	Danone	*Private*	France	7.2
3	5	Dairy Farmers of America	***Co-op***	USA	7.2
6	6	Fonterra	***Co-op***	NZ	6.6
4	7	Arla Foods	***Co-op***	Denmark/ Sweden	6.2
8	8	Kraft Foods	*Private*	USA	5.2
10	9	Unliver	*Private*	NL/UK	5.0
11	10	Friesland Coberco	***Co-op***	NL	4.2
12	11	Meiji Dairies	*Private*	Japan	3.6
13	12	Campina	***Co-op***	NL	3.6

Private firms have overtaken co-ops to get places 3 and 4.

Fonterra is standing still.

Source: Danish Dairy Board

Examples of co-ops with shares listed

- Donegal (IR): conversion and stock listing in 1997
- Calavo (USA), conversion in 2001, stock listing 2002
- National Co-operative Dairies / Clover (SA): conversion in 2003, stock listing in 2004
- Gold Kist (USA), conversion and stock listing in 2004
- Diamond Walnut Growers (USA), conversion and stock listing in 2005
- IAWS (IR): converted in 2005, plans to become stock listed in 2006

Examples of co-ops with two share classes

Cooperatives with a separate classes of equity shares in addition to the traditional ownership rights held by the member of the cooperative:

- Pro-Fac (USA), in 1994: only preferred stock
- Saskatchewan Wheat Pool (CA), in 1996, nonvoting common stock
- CHS (USA), in 2001: only preferred stock

Examples of co-ops with separate listed subsidiaries

- Kerry (IR), in 1986
- Metsäliito / M-real (FI), in 1987
- IAWS (IR), in 1988
- Avonmore (IR), in 1989 (now Glanbia)
- Waterford (IR), in 1989 (now Glanbia)
- Golden Vale (IR), in 1989 (in 2001 acquired by Kerry)
- Atria (FI), in 1991
- LSO Cooperative / HK Ruokatalo (FI), in 1997
- Emmi (CH), in 2004

Bibliography

- The comments on control in these slides are drawn from Bengt Holmstrom, Prof of Economics at Massachusetts Institute of Technology, in a 1999 paper on the future of cooperatives

- Example of co-ops with different capital structures – taken from Bijman + van Bekkum, “Co-operatives going public: motives, ownership, and performance”, International Conference on Economics and Management of Networks – Budapest, 15 – 17 September, 2005