INTELACT

2004 HAMITON CONFERENCE

FONTERRA

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Outline

Caveats

This is the second of a two part presentation. The first part was given at Intelact's 2003 Conference in Rotorua.

This second part is 'work in progress'. It is a draft pending completion shortly.

Its format is different from the Intelact Conference. It is better suited to reading on a home computer.

Additional material has been included. All sources are publicly available.

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The diagrams are in several colours and therefore may copy well in black and white.

Section 1:
My Perspective

Background

- Independent adviser on regulatory issues, law and public policy
- Leader, Producer Board Project Team (1999)
- Policy adviser (apolitical), Department of the Prime Minister and Cabinet (1991 – 98)
- Lawyer, Thomson-CSF, an French-based electronics multinational (1990-91)
- Lawyer, Chapman Tripp, Wellington (1984 – 89)
- Bachelor degrees in law and commerce

Purpose

This is a general information kit about Fonterra and the NZ dairy industry. Its purpose is:

- To improve understanding among interested parties, including dairy suppliers, advisers and analysts, business and rural media, the corporate sector and government officials
- To improve the quality of scrutiny in relation to Fonterra
- To encourage positive change

Feed-back welcome – tbaldwin@ihug.co.nz

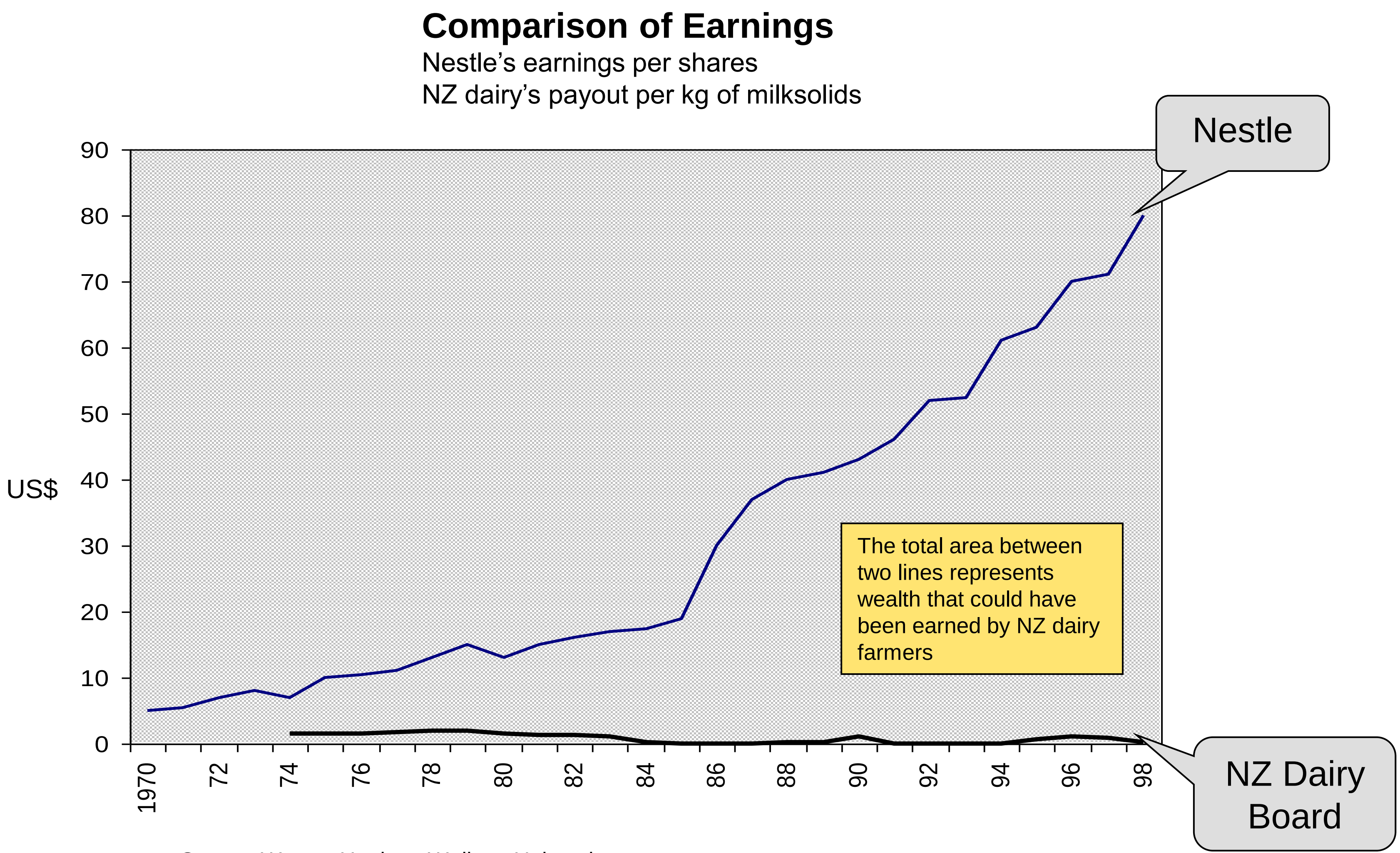
Framework

- I am keen to see Fonterra and the NZ economy succeed
- Economic success requires effective pressure on directors from resource-owners to deliver returns at least equivalent to the next best alternative use of those resources with a similar level of risk
- If a group of directors fail to achieve competitive risk-adjusted returns, resources should be freed up for use by another group of risk-takers
- Diversity of ideas and mobility of resources are key to a successful economy
- A fundamental problem in the dairy industry for the last 80 years has been a lack of diversity and limited mobility of resources

Reason for interest

- Fonterra uses significant resources in the NZ economy (7% of GDP, 23% of exports), which should be freed for use in other activities if underperforming
- It faces weak performance scrutiny compared to other large businesses
- It is not achieving adequate returns for shareholders, taking into account opportunity costs

Opportunity cost



Source: Warren Hughes, Waikato University
Note: Both lines exclude capital gains (on Nestle shares or suppliers' land)

Reason for interest *(cont'd)*

- Fonterra needs shortly to make key decisions on capital structure and strategy
- However, its outlook is constrained by politics, history and ideology
- Leaders have a long tradition of 'spin' and failing to give shareholders full information
- Deeper and more informed participation is required

Section 2:

Executive Summary + Recommendations

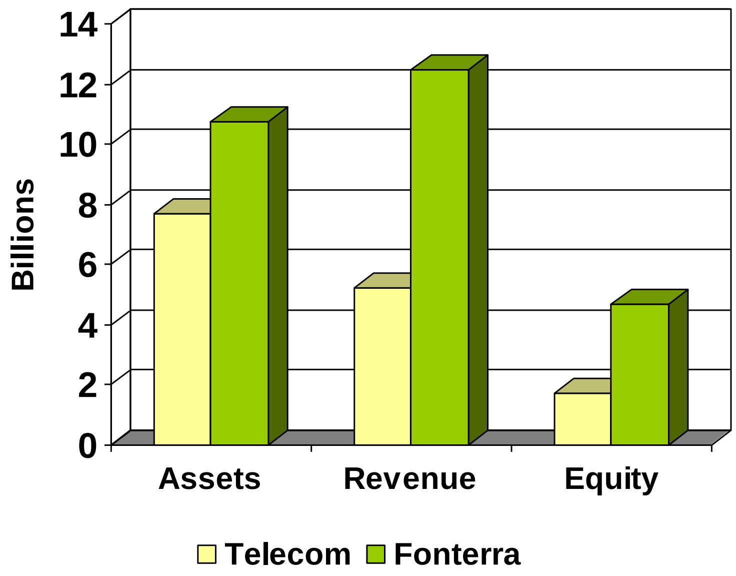
- TO COME

Section 3:
Market Context

This is a reasonably lengthy background section which seeks to put Fonterra and the NZ dairy industry into a general market context

Largest NZ company

	Telecom *(30 June 03)*	Fonterra *(31 May 03)*
Total Assets	$7.7b	$10.75b
Revenue	$5.2b	$12.5b
Equity	$1.7b	$4.7b



Fonterra buys about 97% of all milk produced in NZ. It was formed in 2001 by special legislation which allowed it to by-pass normal Commerce Commission processes

But not huge

- In 2001, it was argued that merging the Dairy Board, Kiwi and NZ Dairy Group would create ‘critical mass’ necessary for NZ dairy to compete against the dairy food giants and have some strength in selling to the large global retailers. This argument was misleading

- The 2001 ‘mega merger’ did not, in itself, change the NZ industry’s scale or ‘critical mass’. Revenues have increased as a result of buying into Australia and entering into various JVs and alliances

- In reality, Fonterra is not a giant or a niche player

- Its ability to grow is limited by its relatively small and ‘capped’ base of share capital (13,000 NZ suppliers)

World dairy rankings

2003	1996	Company		Country	2003 dairy sales US$b	2003 parent sales US$b
1	1	Nestle		Swiss	15.3	54.25
2	13 + 17	Dean Foods		USA	7.1	8.91
3	2	Dairy Farmers of America	*Co-op*	USA	6.4	Nil
4	15	Arla Foods	*Co-op*	Denmark/ Sweden	6.1	Nil
5	4	Danone		France	6.0	12.74
6	22	Fonterra	*Co-op*	NZ	5.8	Nil
7	12	Parmalat		Italy	5.8	7.95
8	25	Kraft Foods		USA	5.3	29.73
9		Lactalis		France	5.2	
10		Unliver		NL/UK	4.9	25.67
11	4	Friesland Coberco	*Co-op*	NL	4.3	Nil
12	8	Meiji Dairies		Japan	4.2	
13	9	Bongrain		France	3.7	

Snow Brands, Japan, US$8.5b sales

Source: Danish Dairy Board + Food Engineering 2003

‘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

Cheap feed

- NZ dairy's main competitive advantage is low cost feed (grass) year round – under 5c/kg dry matter (DM)

- Only 10% of dairy cows in the world have pasture grazing as the major component of their total food intake

- Feed for overseas rivals costs a lot more (but is also more energy-rich producing more milksolids per cow):
  - Hays: 20-30 c/kg DM
  - Silage: 10-20 c/kg DM
  - Grains: 30-60 c/kg DM

- Grass is lower energy" 10-12 mega joules of metabolisable energy per kg of DM (depending on season and pasture condition). Therefore milk production per cow is relatively low in NZ – on average about 4,000 litres per year

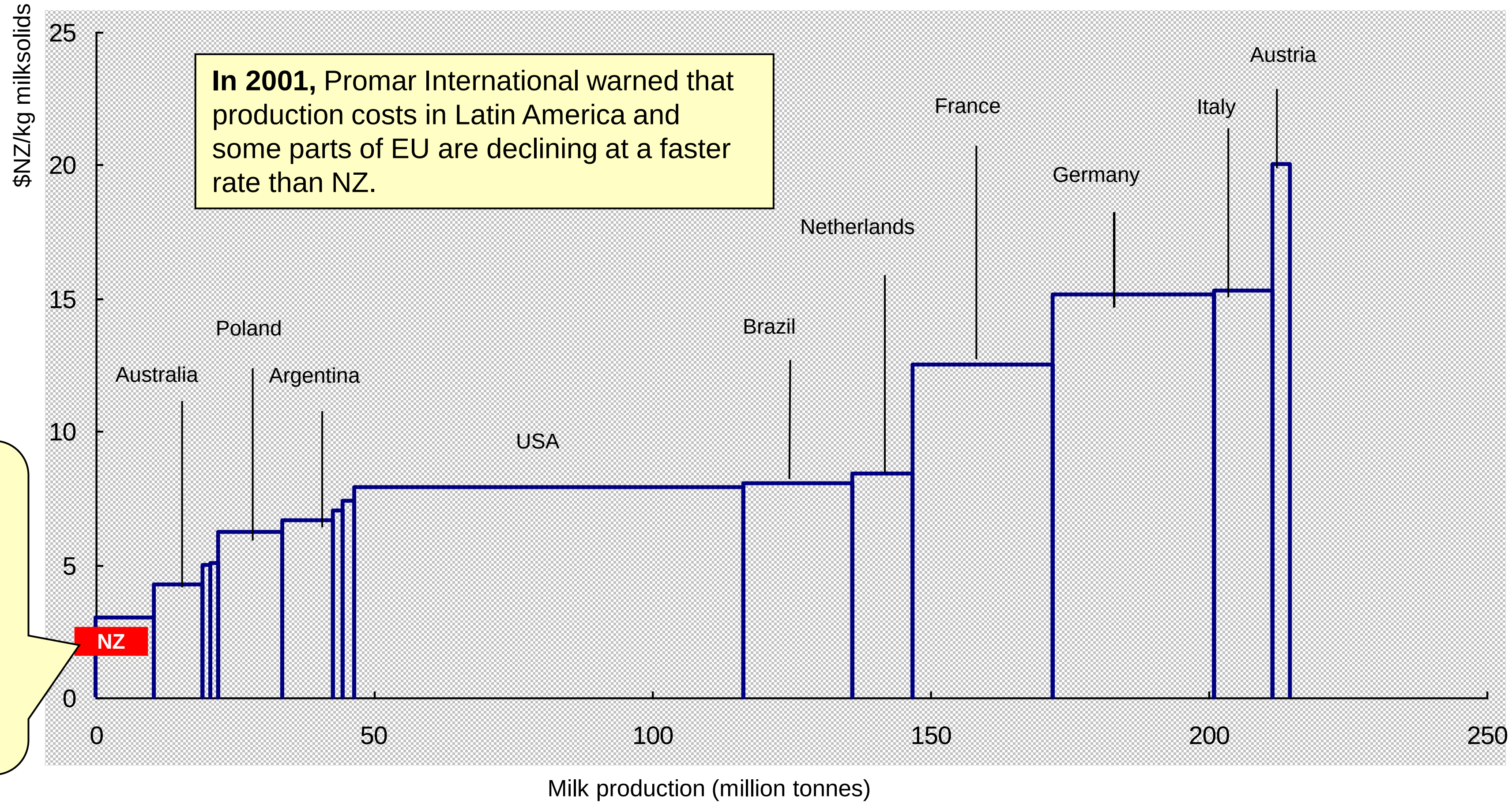
- By contrast, in the northern-hemisphere it is about 10,000 litres per cow per year, using higher energy feeds (with high Govt supports)

Other cost advantages

- Low cost water and electricity has been key to NZ production growth over last 20 years
- Unlike, many competitors, no need for seasonal housing – cows kept outside year round
- Avoid extra labour for feeding and mucking out faced by many competitors
- However, key cost drivers of dairy farm profitability are:
  - Milksolids produced per hectare, and
  - Cost of capital

Lost lowest cost ranking

Source: McKinseys 1999, IFCN Milk Report, USDA-FAS, OCED



In 2001, Promar International warned that production costs in Latin America and some parts of EU are declining at a faster rate than NZ.

In 1999, NZ lowest cost **By 2004,** NZ is overtaken as lowest cost by Sth American firms

Fonterra pays a lower raw milk price (63% of Irish in 2002) on lower input costs (37% of Irish in 2002)

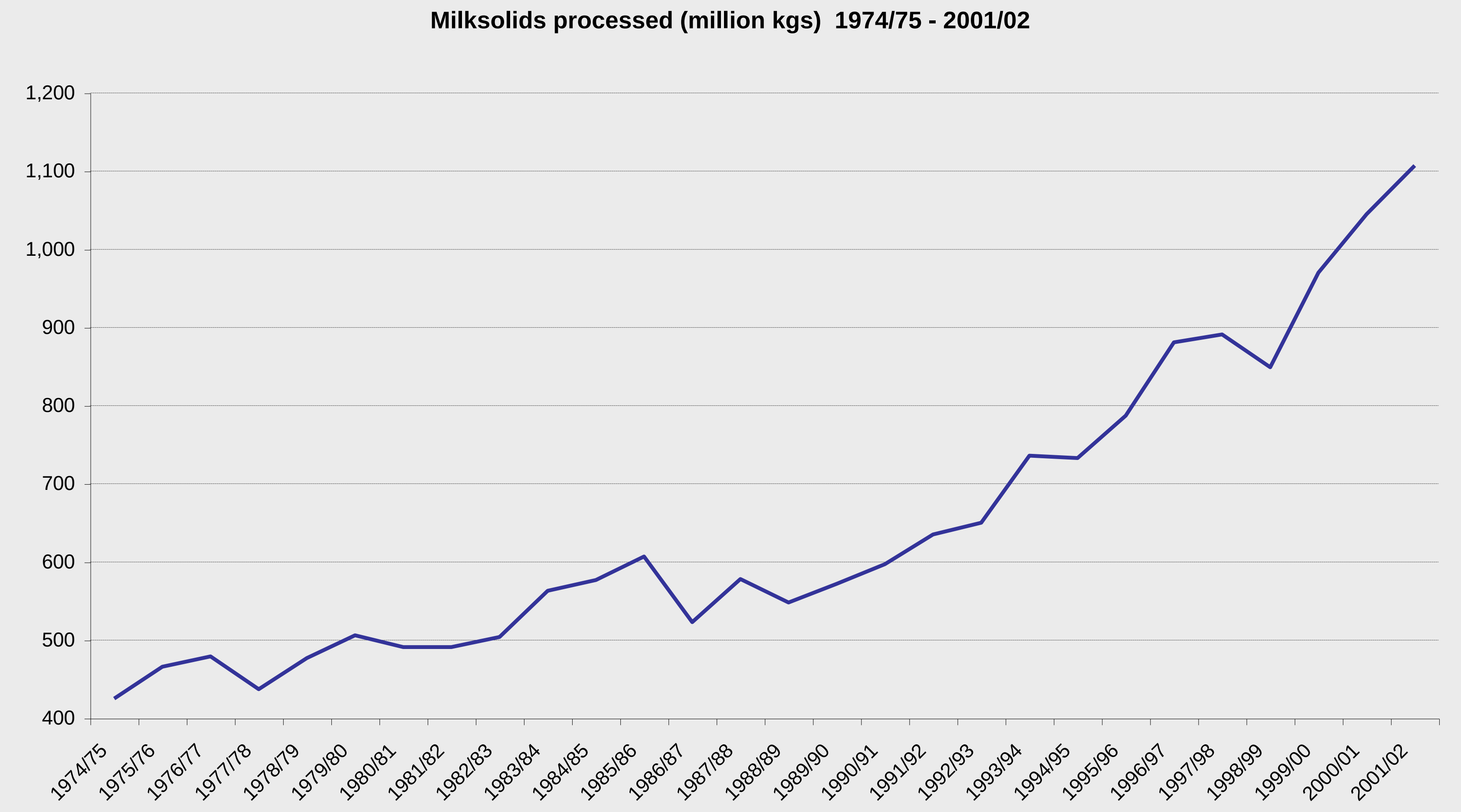
Twofold strategy

Primary focus of NZ industry over last 20 years has been:

- To increase production, mainly by improving:
  - Pasture management (increase metabolisable energy per hectare)
  - Bovine genetics (increase cow efficiency in converting pasture to milksolids) – 85% of the national herd is artificially inseminated
- To improve cost efficiencies, mainly by increasing the scale of:
  - Processing plant, and
  - Farms

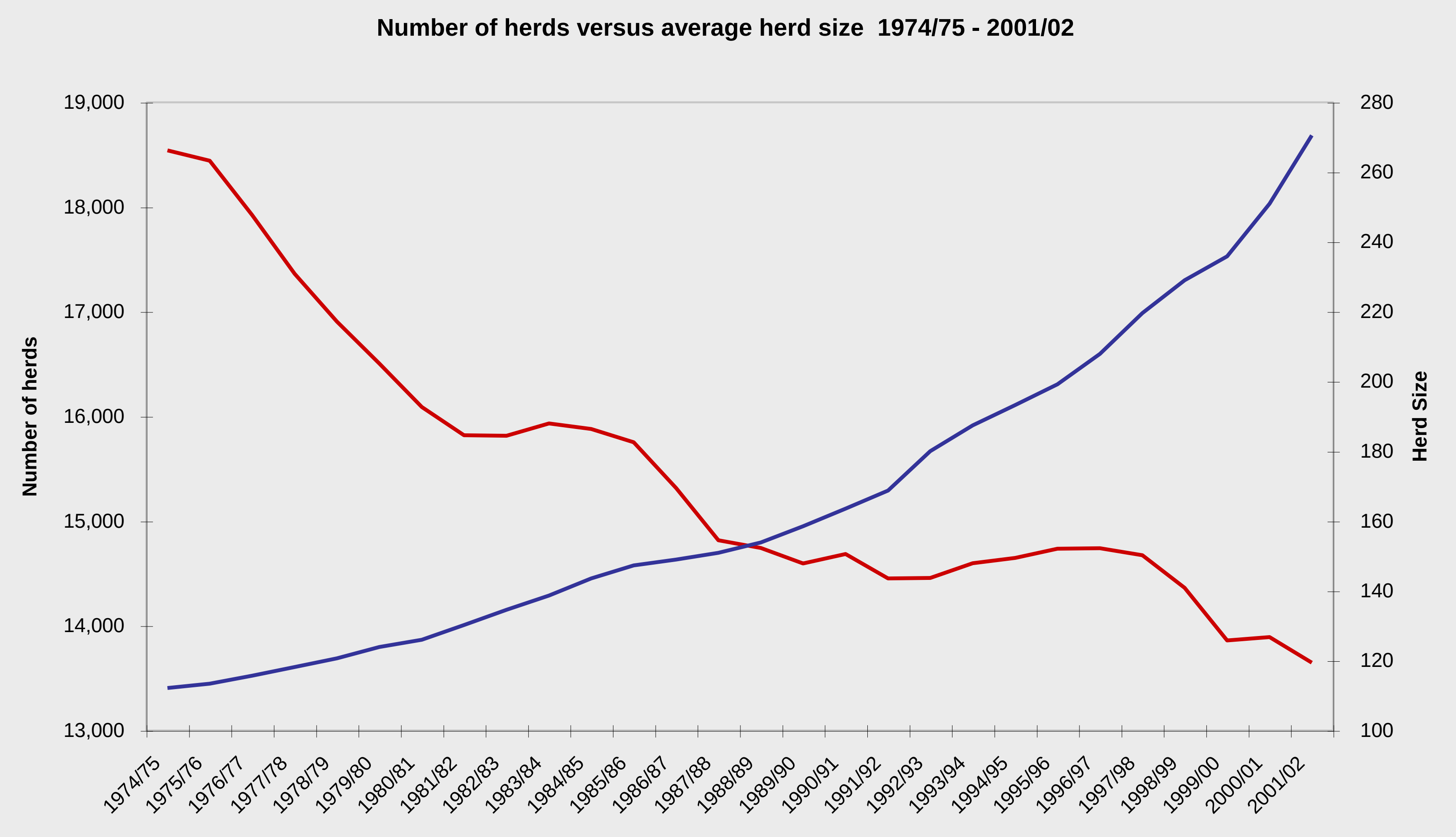
Grow production

Milk volume doubled since 1982/83 (CAGR over the last ten years is about 6%)



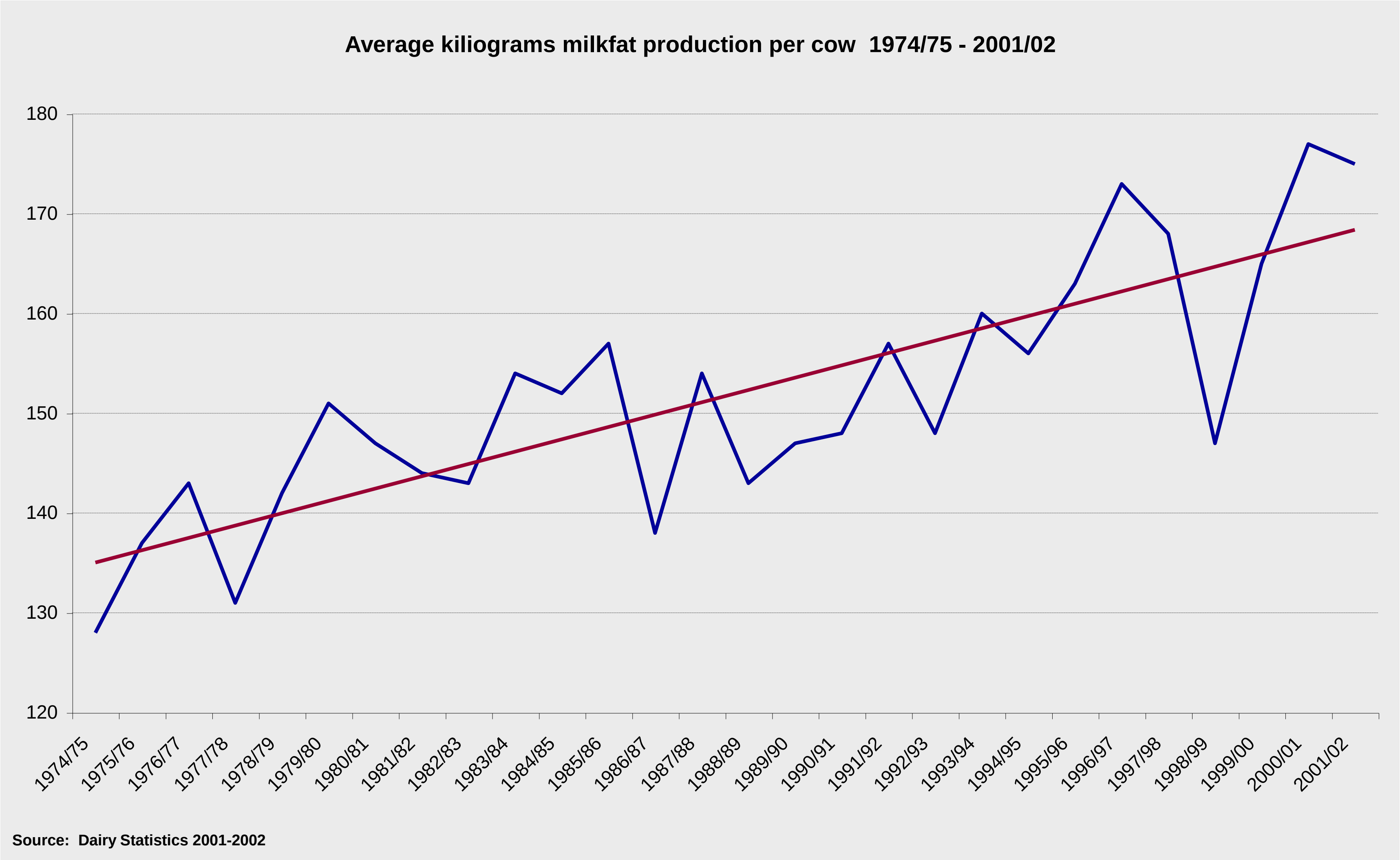
Source: Dairy Statistics 2001-2002

Increase farm scale



Source: Dairy Statistics 2001-2002

Increase cow output



10 year trends

	1993	2003	% Change
Production	7.6 billion litres	13.9 billion litres	+82.8%
Average cost of production (in 2003 dollars)	$1.91/kgMS	$2.55/KgMS	+33.5%
Average farm size	74 ha	111 ha	+50.0%
Average herd size	180	285	+58.3%

NZ milk production is still increasing. Fonterra's 2002 projections show continued growth. Fonterra's "expected" scenario is a 20% increase over the next 10 years

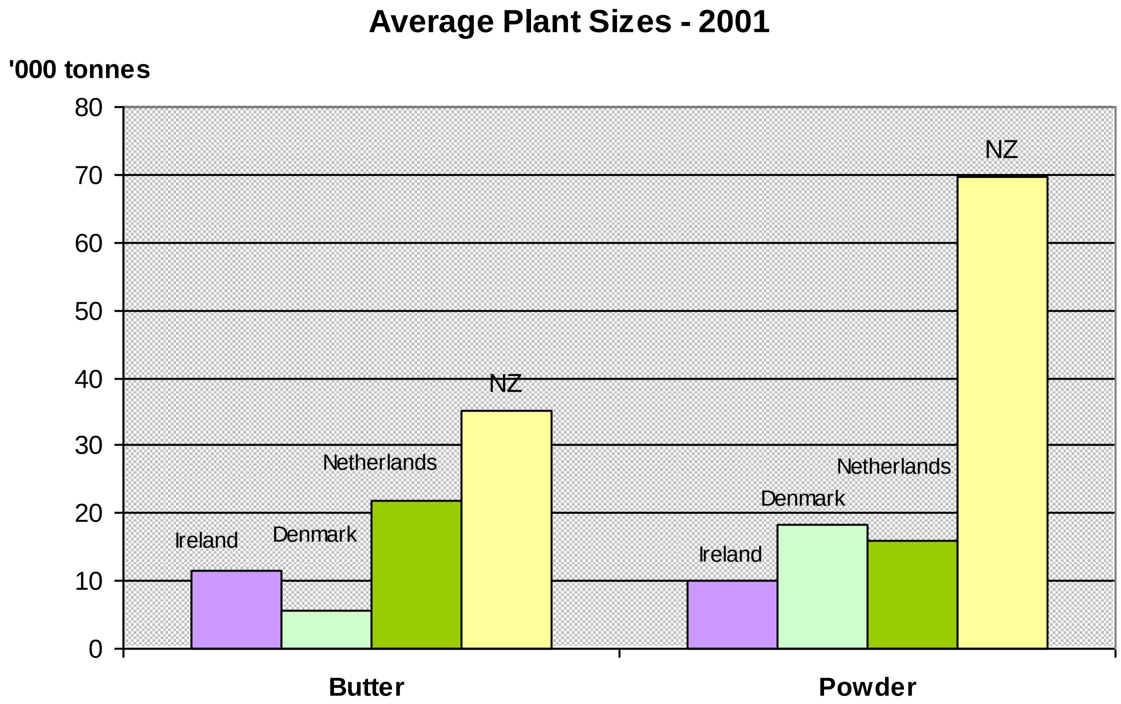
Big seasonal peak

- About 70% of NZ’s annual production is delivered over 5 months (240 – 300 days): June – May, with a high peak in October
- By comparison, northern hemisphere processing only varies year-round between 80-100% of peak milk flow
- Fonterra therefore has low capacity utilisation
  - NZ at 50% compared to Denmark and Netherlands at 90%

Large plant

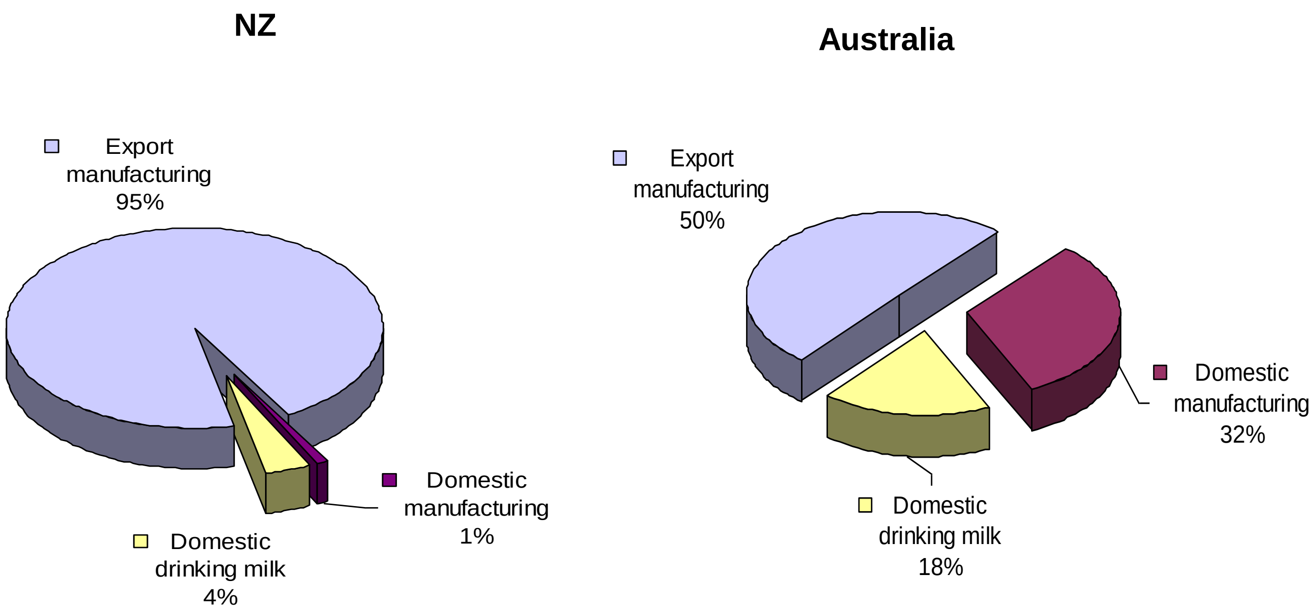
- NZ response to seasonality has been to build larger peak capacity to lower unit costs (see graph below)

- Fonterra can't give 12 month customer service without overseas milk



Source: Promar International, Prospectus

Most NZ milk exported



Source: Livestock Improvement Corporation, ABN Amro

Heavy commodity focus

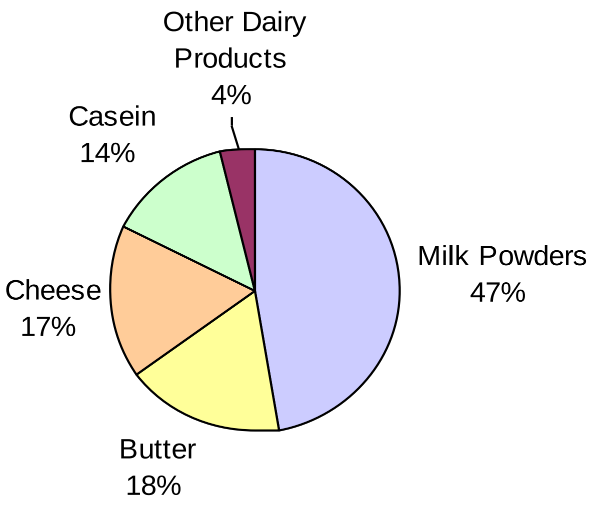
- Hard to sell fresh products from NZ due to:
  - Distance to markets, and
  - Inability to store short shelf life products

- Cooperatives also ‘obliged’ to take all milk produced, so heavily driven by production, not customer demand

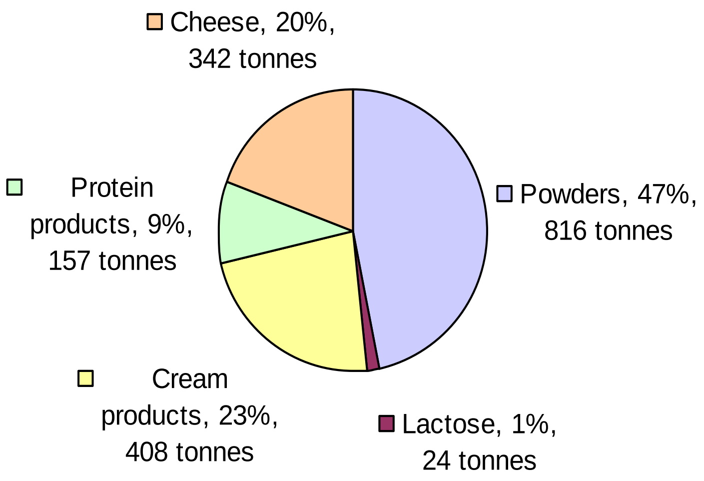
- NZ dairy therefore focused on storable (low margin) products
  - butter, hard cheese and milk powders

Powders dominate

Total NZ Dairy Exports
(by value) YE March 2004



Fonterra's Production Mix
(by tonne) 2002

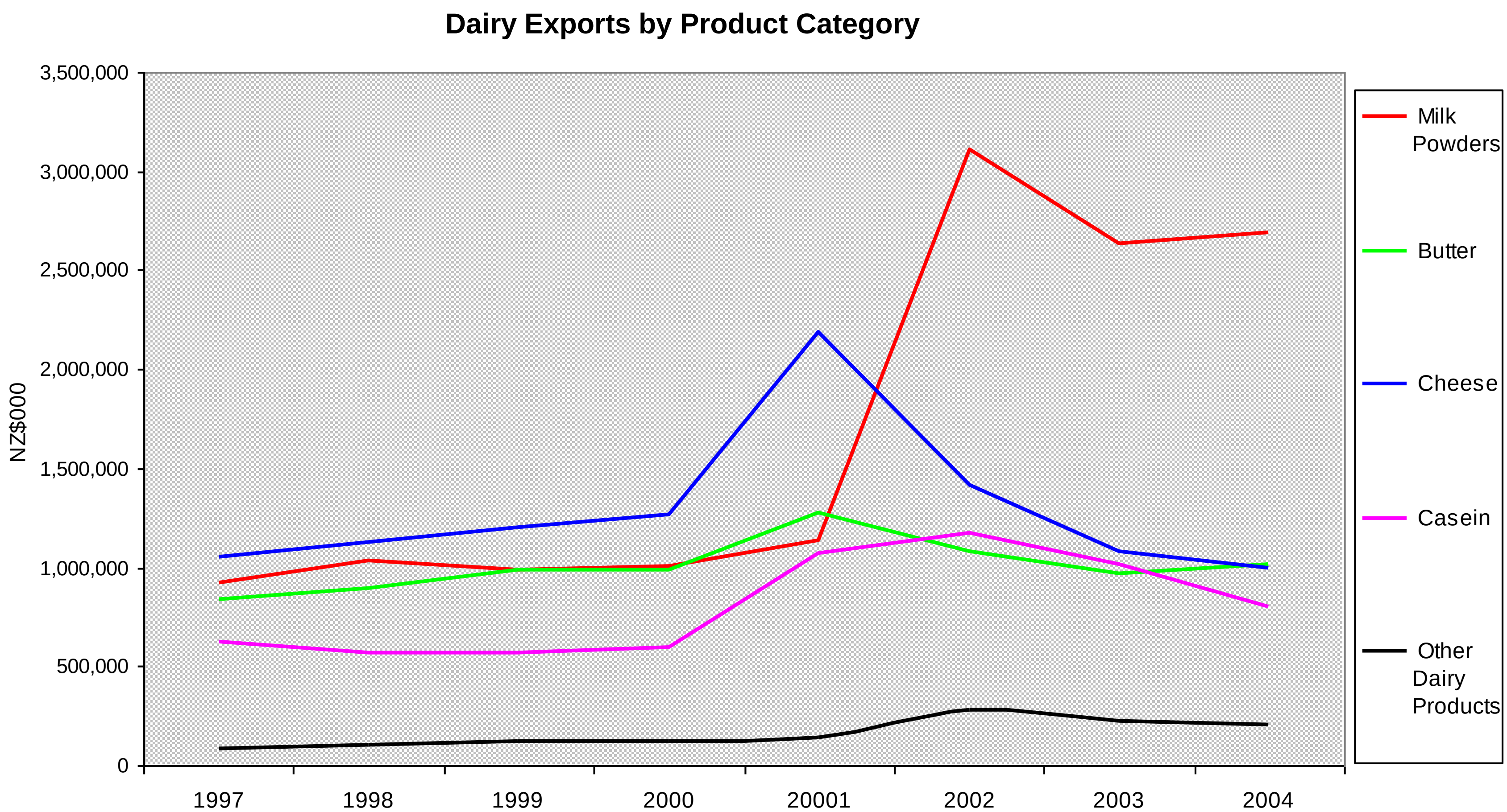


Source: NZ Trade + Enterprise

Butter + SMP + WMP as % of total output in:

NZ:	65%
Denmark:	22%
Netherlands:	13%

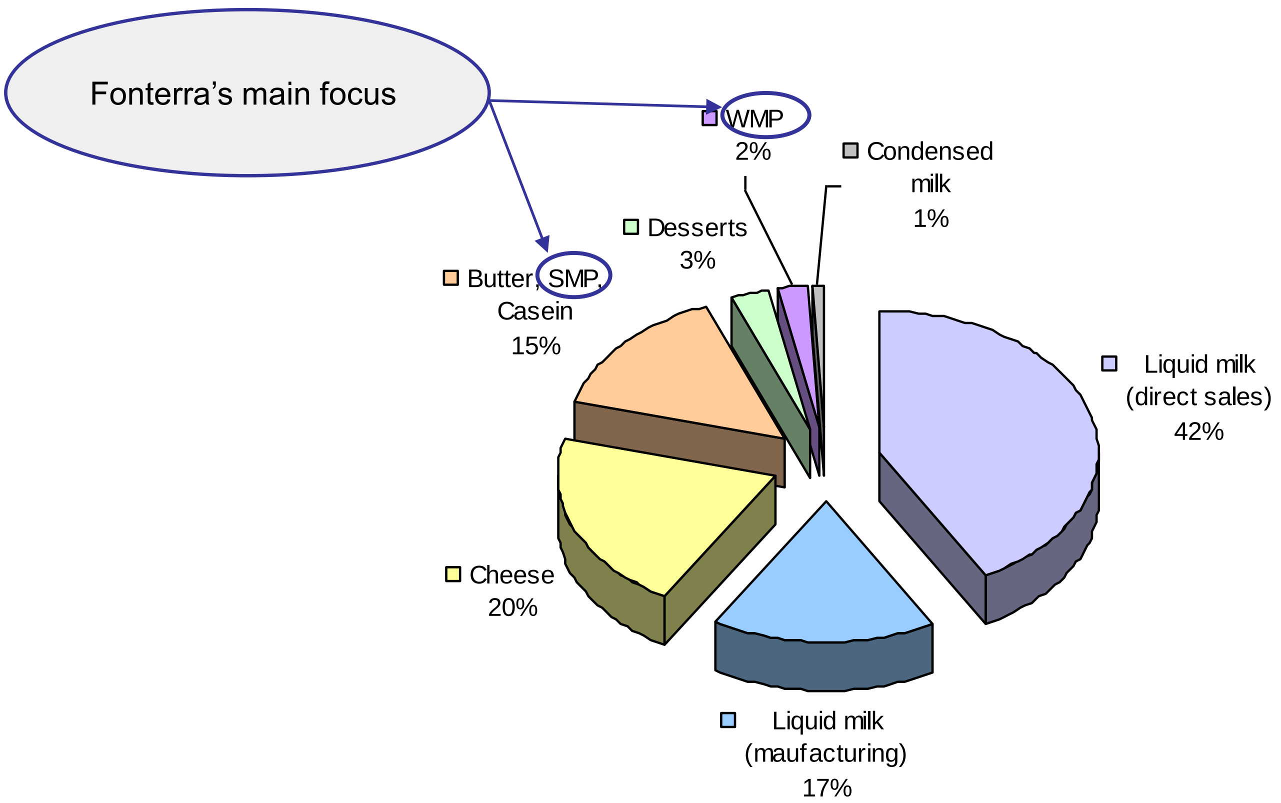
Powder up under Fonterra



Source: NZ Trade + Enterprise

World dairy production

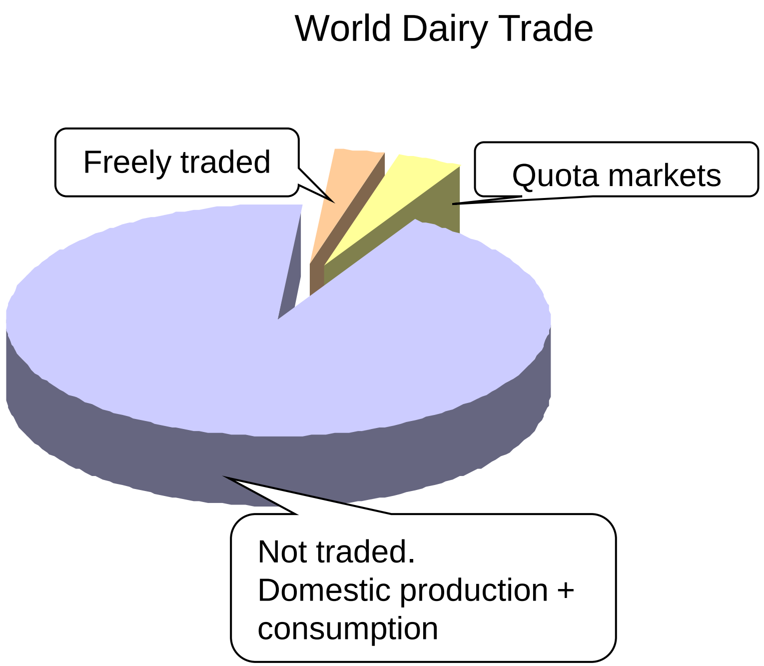
Use of Raw Milk Worldwide



Source: Rabobank, World Dairy Market Report

Limited world trade

- Most dairy production around the world is consumed locally
- Only 7% of dairy production is traded. Fonterra has around 35% of the 7%
- Wealthy markets – EU, USA, Canada + Japan – are heavily protected by tariffs and subsidies



Unsophisticated trading

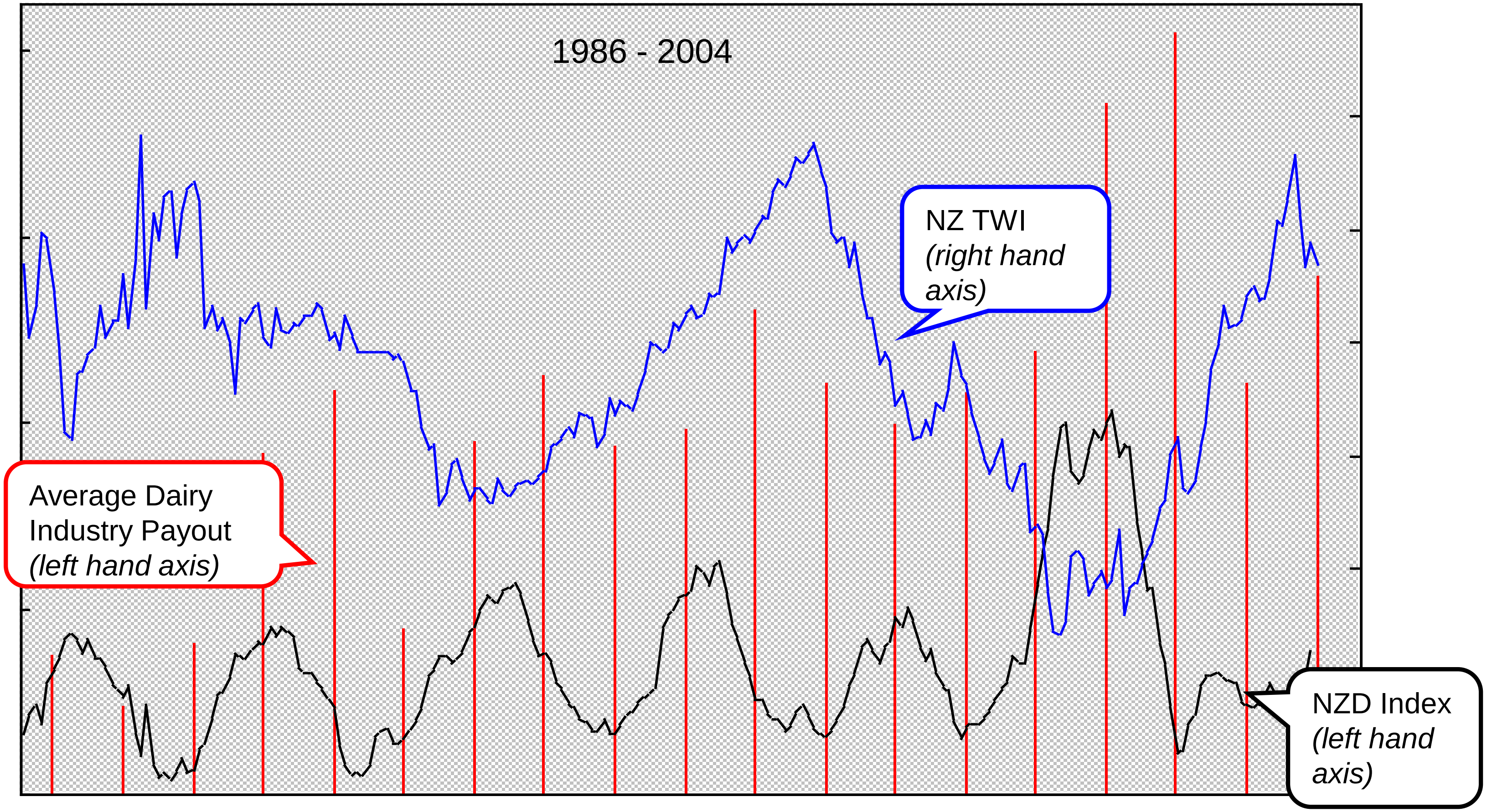
- With limited international trading, dairy commodity markets are unsophisticated compared to more widely traded commodities eg gas, oil, bonds, aluminium, gold, other minerals, pork bellies and poultry
- Forward and derivatives markets for commodities are essential in managing risk effectively. They have not yet developed for dairy
- Within this context however, Fonterra is a relatively sophisticated global supply chain

No market power

- In basic commodities, Fonterra is ‘price taker’
- Over many years, NZ dairy leaders have perpetuated a myth that NZ has market power – an ability to achieve higher prices for its basic dairy commodities:
  - These claims of ‘market power’ have now been widely and authoritatively rebutted by Prof Evans and many others
  - Finlayson, Lattimore, Ward determined in 1998 that if NZ reduced exports by 10%, world price would fall by less than 0.5%
- 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

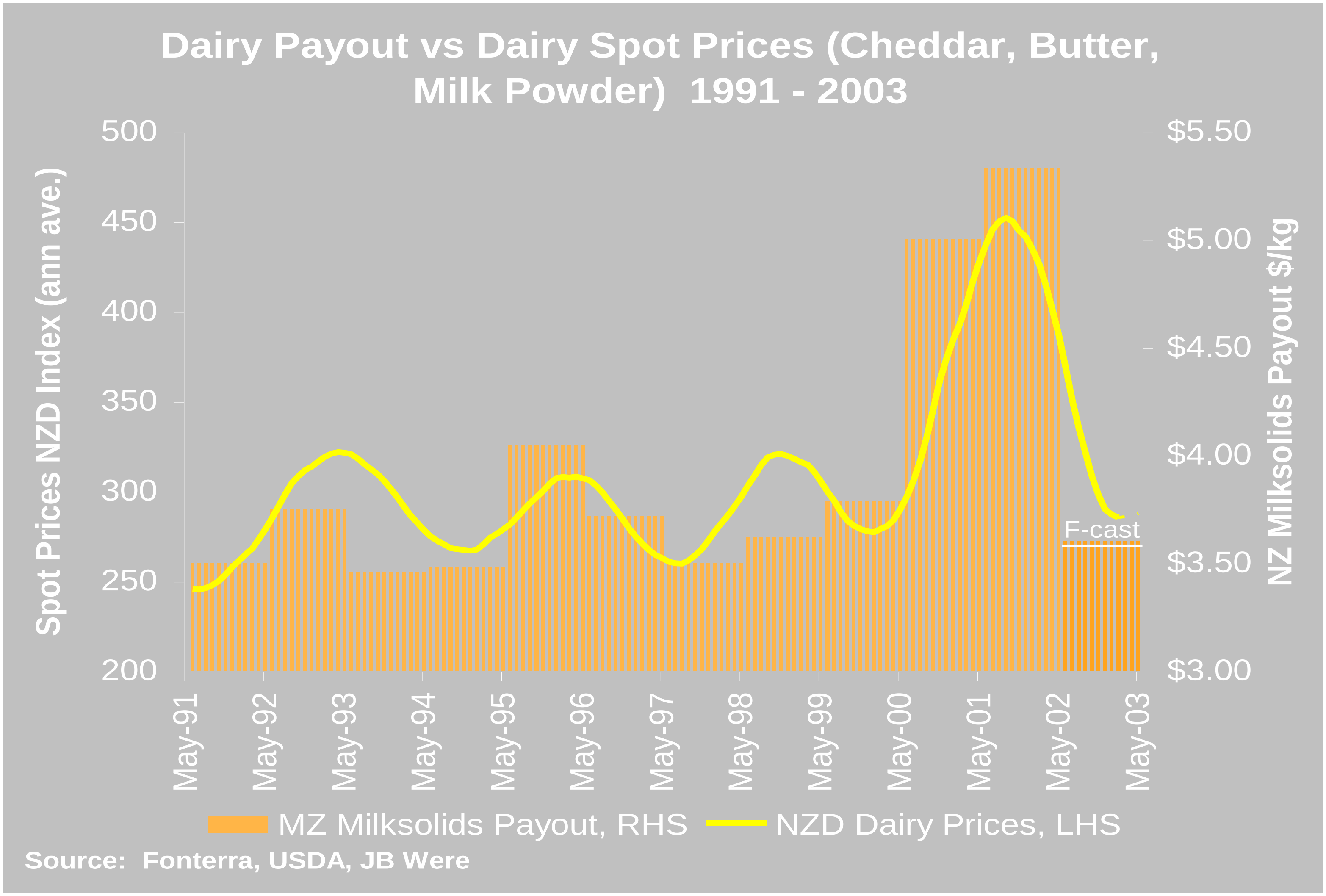
Inherent volatility

- Volatile prices and exchange rates are inherent in dairy commodities



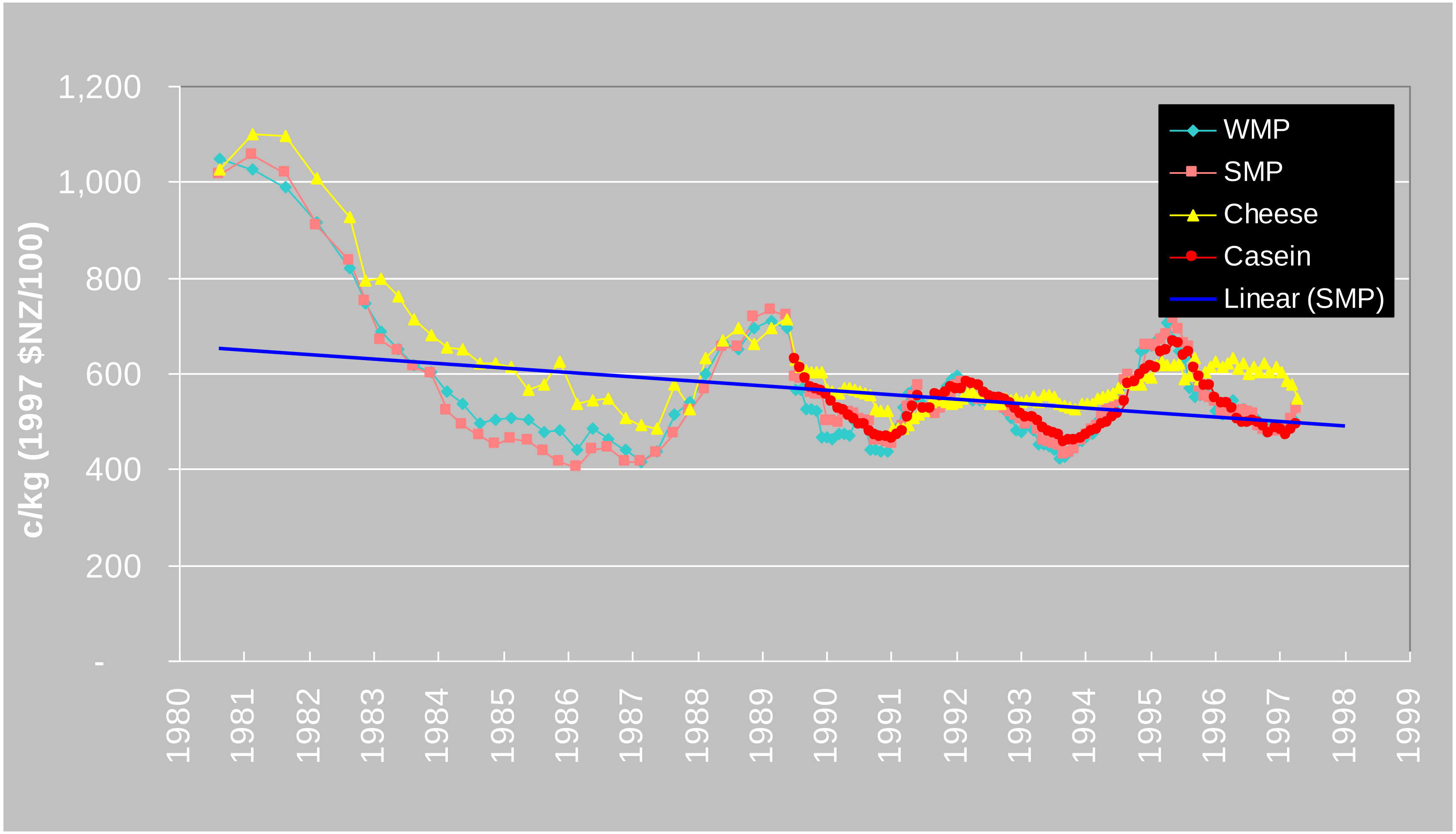
Sources: ANZ, Datastream, Baldwin

Inherent volatility *(cont'd)*



Product prices tracking down

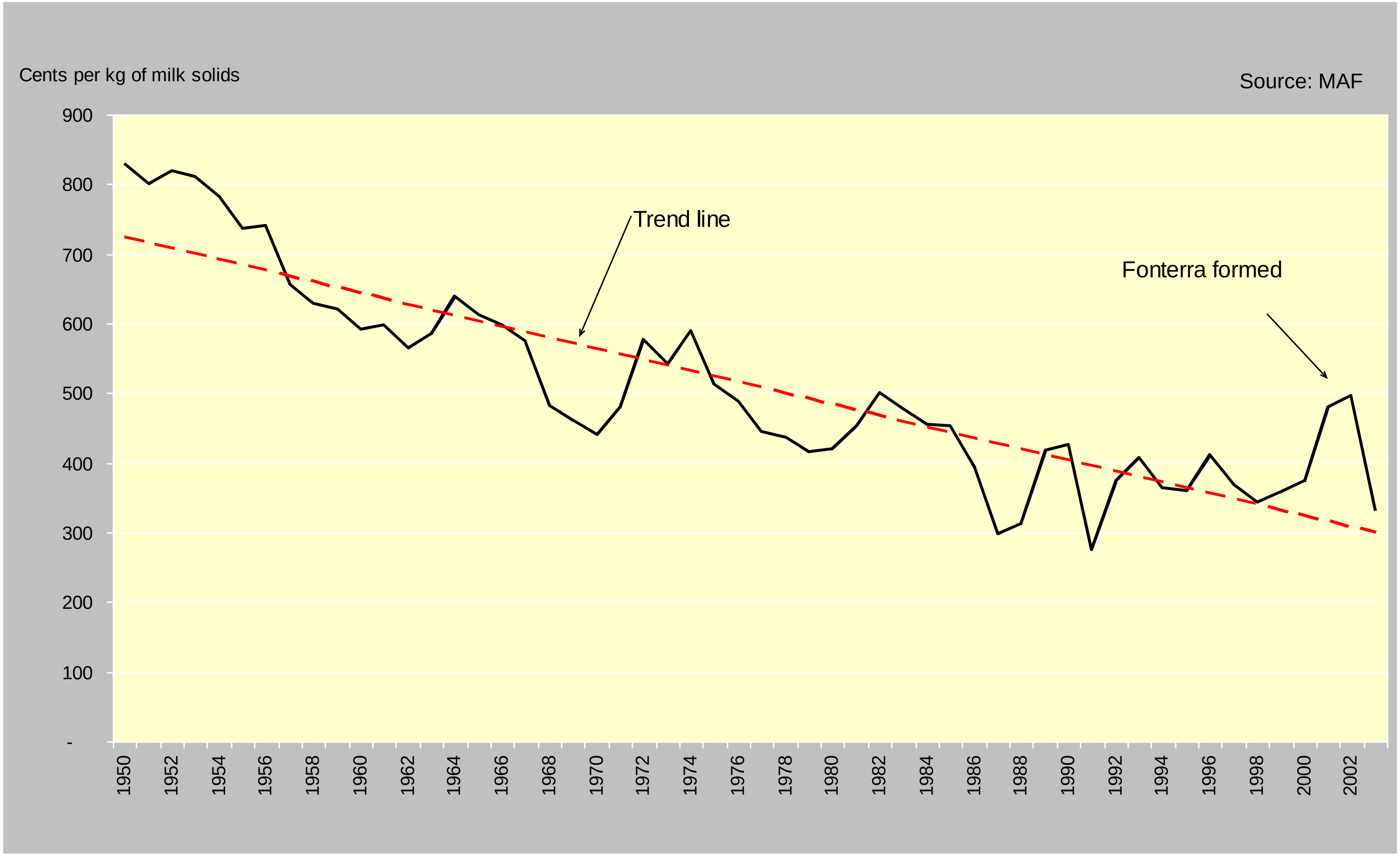
Inflation adjusted



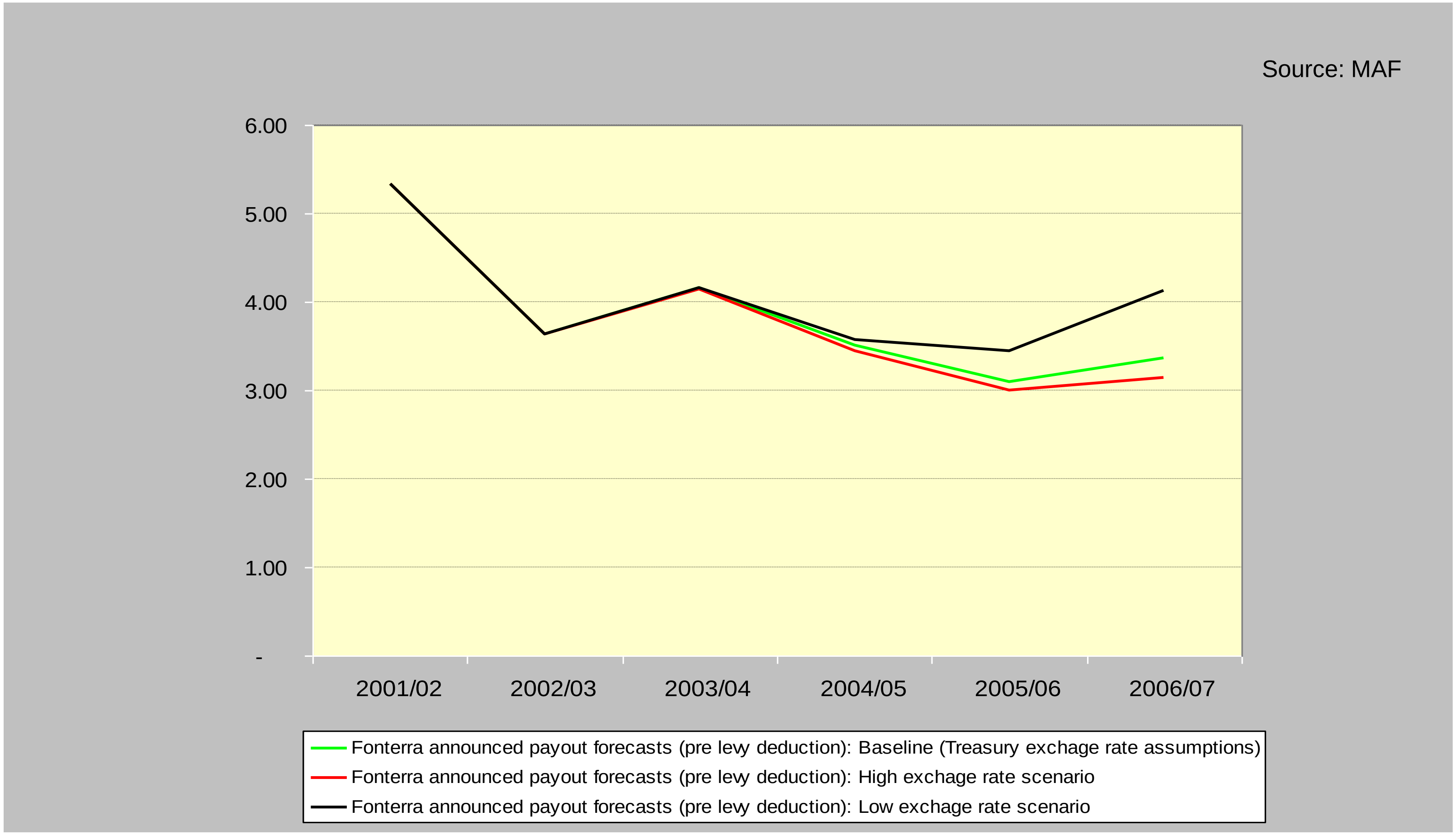
Source: McKinsey 19999

Commodity revenue has declined in real terms by 2% pa over the last 20 years

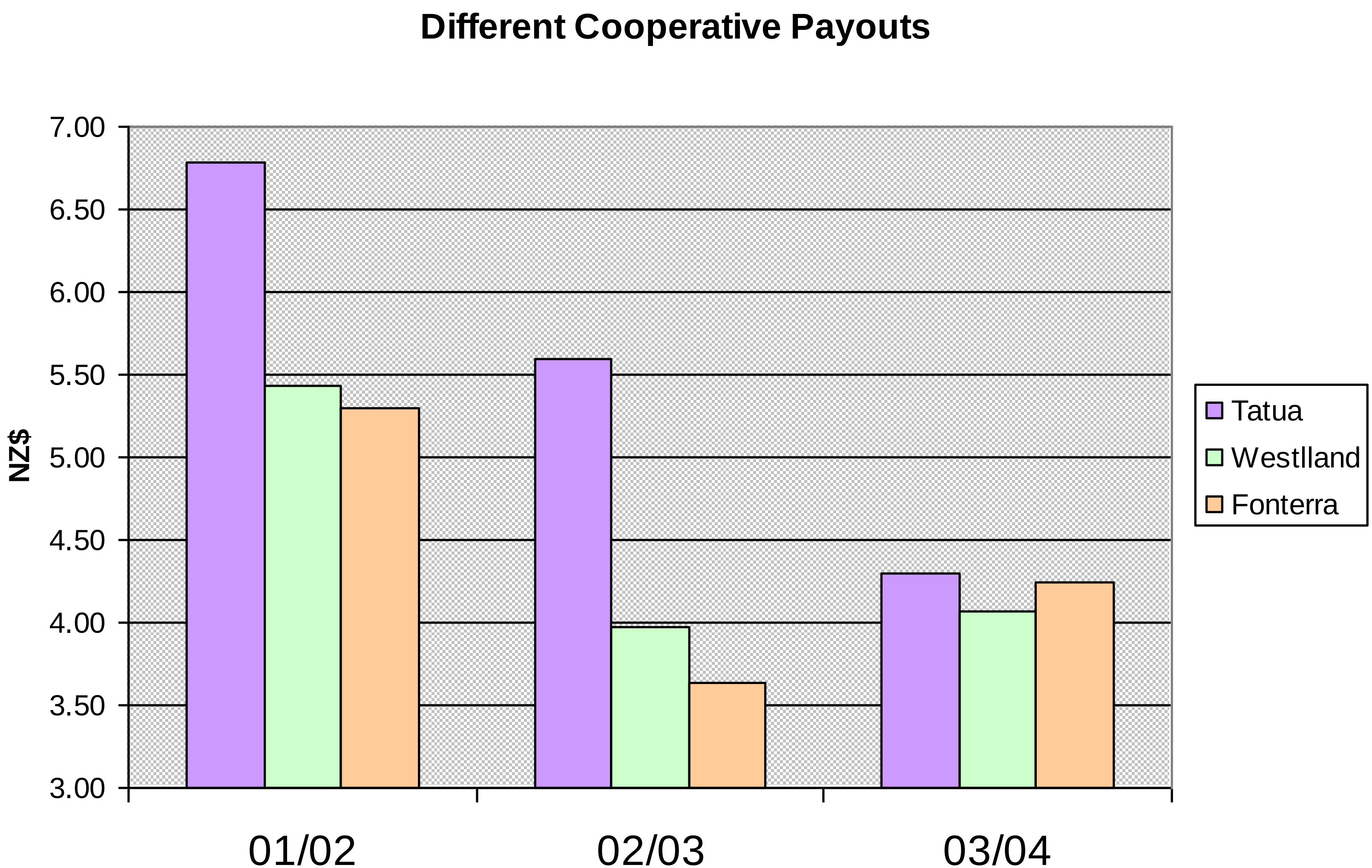
Real milk payout falling



Forecast payout down



Comparative payouts



Farm profitability

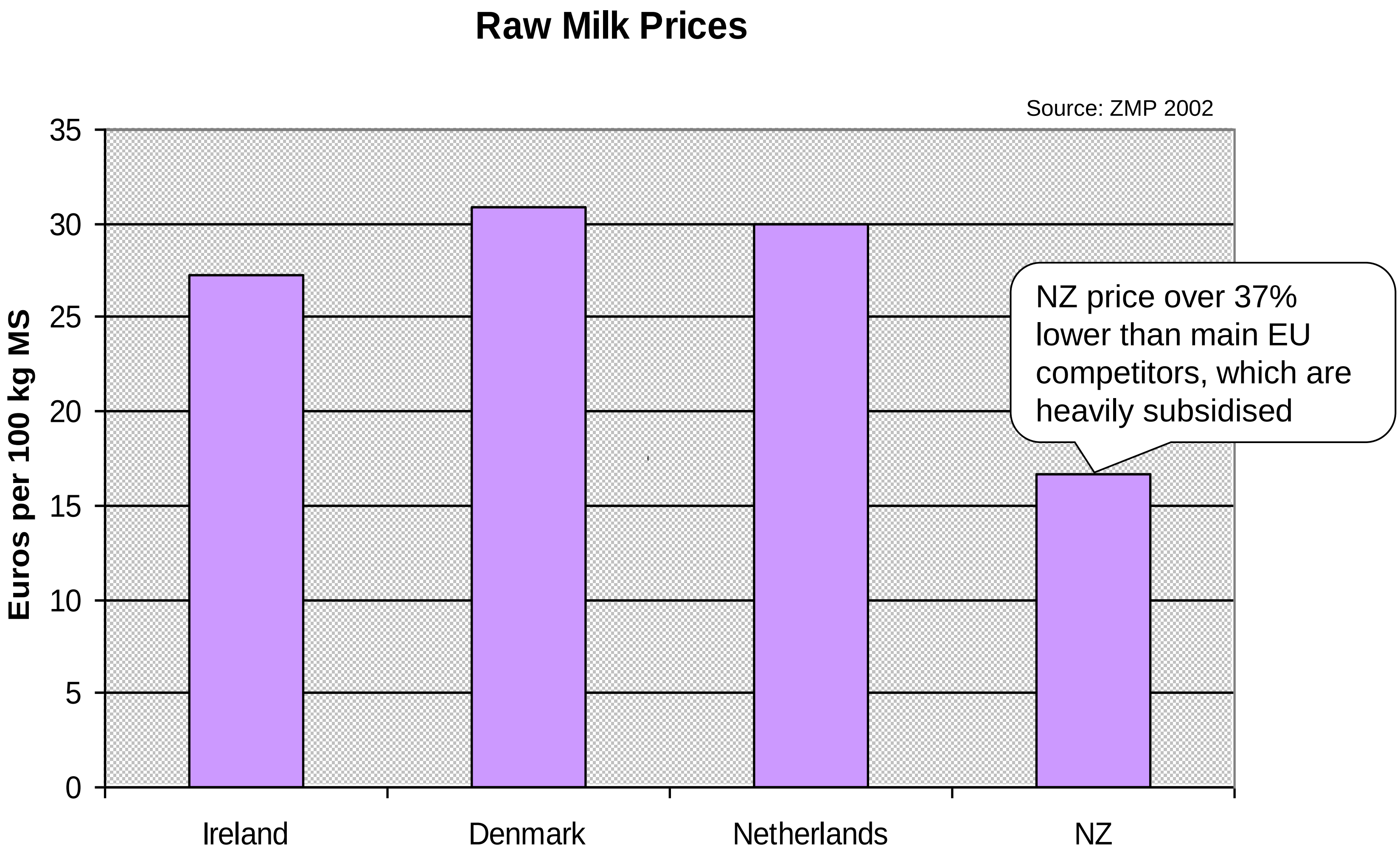
"Few farms cover their full economic costs (land, labour, capital and opportunity costs)."

"The larger NZ farm [in the study] generates a good return to family labour but the smaller 225-cow farm is not able to deliver the average hourly wage rate to its family"

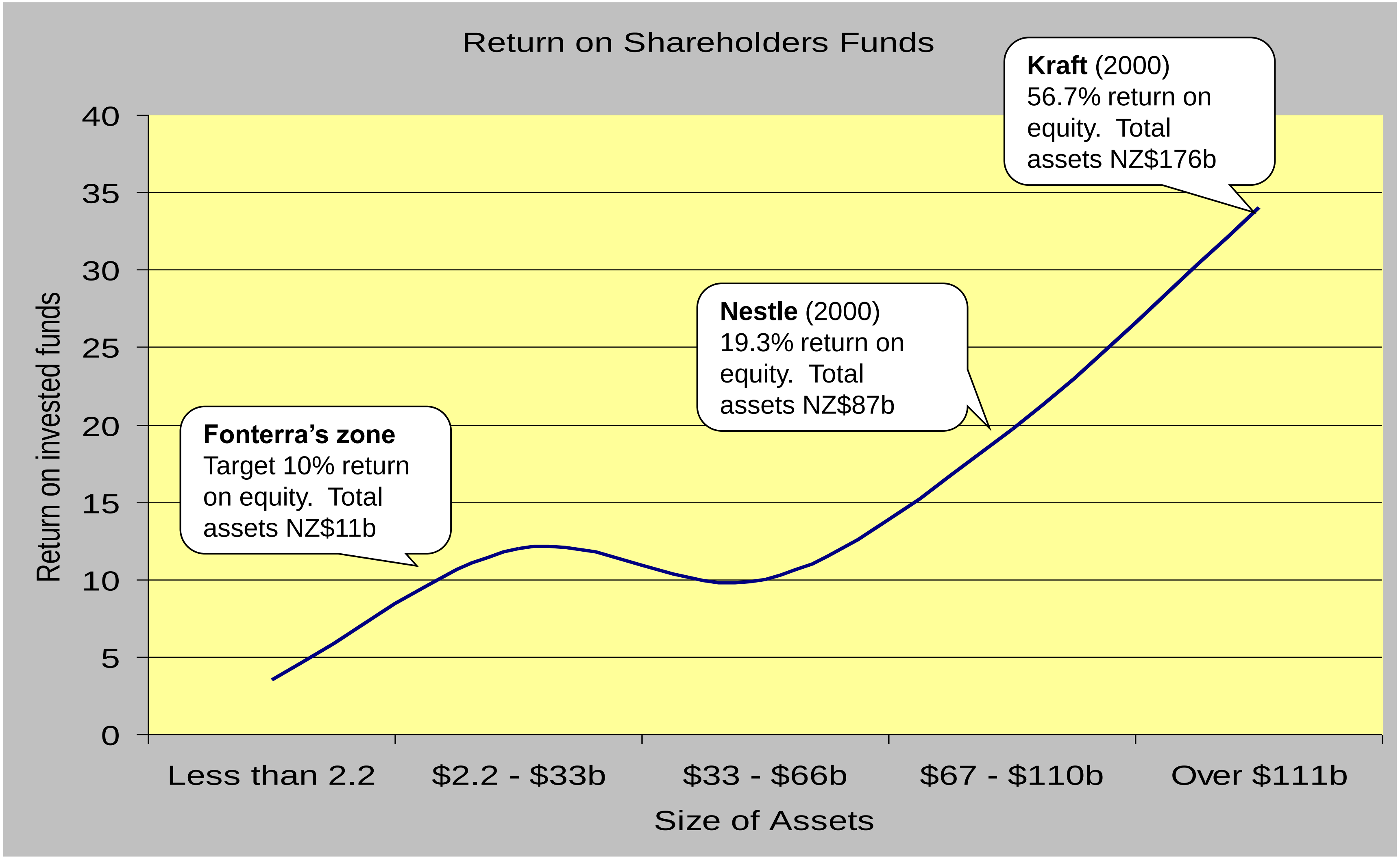
"The profitability of NZ dairy farmers, on average, could be classed as **uncomfortably low** in the competitive world dairy environment"

Nicola Shadbolt, Massey University, 2002

Comparative payout

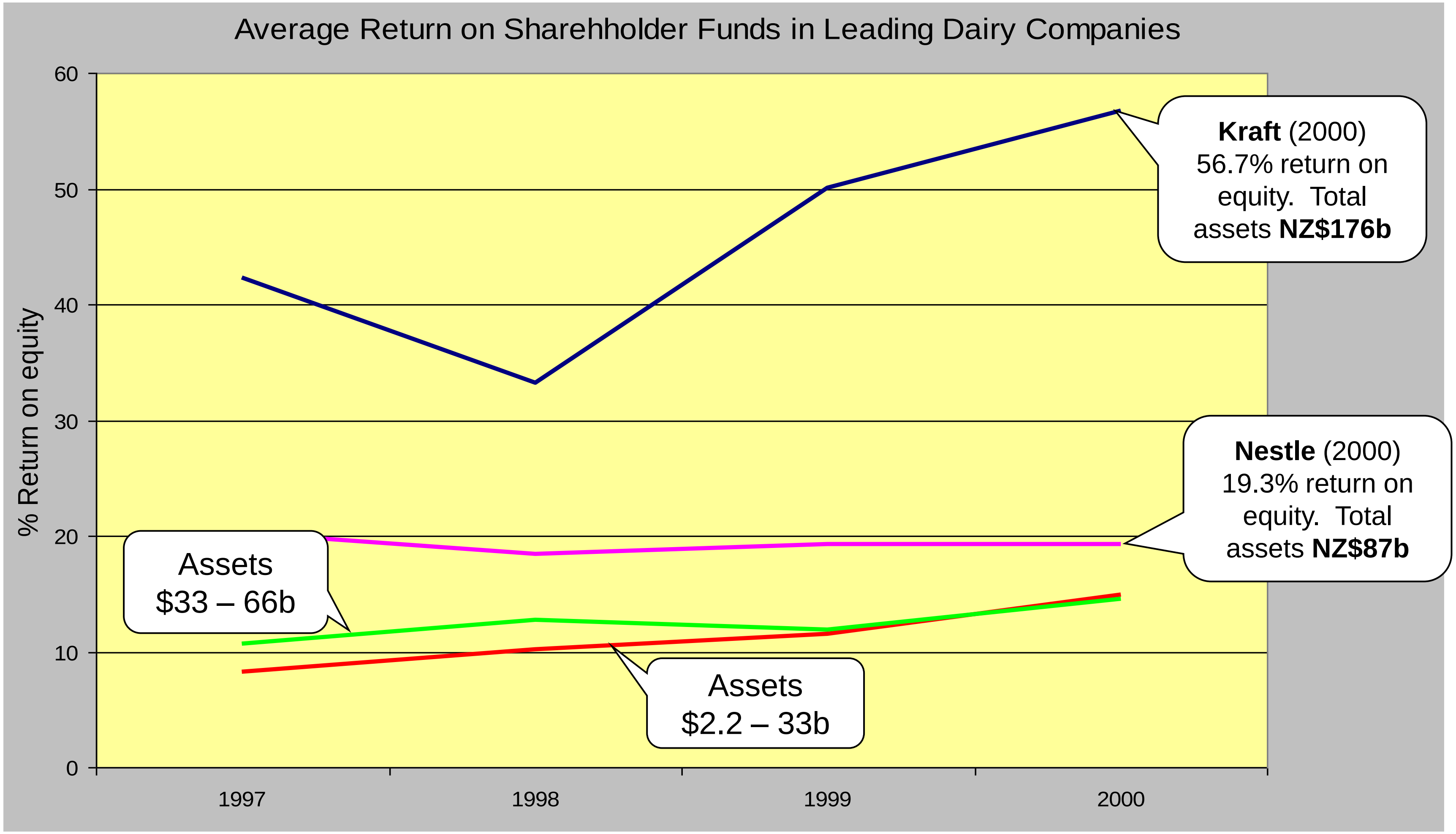


Returns relative to scale



Source: Promar International

Returns relative to scale



Source: Promar International

International forces of change

- Competitors are continuing to consolidate and increase in size
- Power rests with retailers and food service industries
- Govts are removing special supports for cooperatives
- Competitors are making gains from new biotechnologies
- Trade liberalisation is still relatively slow
- Traded milk volumes are increasing, creating more competition
- Consumer demand has shifted toward more highly processed products – therefore an increasing proportion of the consumer’s dollar accrues to activities beyond the farm gate
- Competing for higher margin products involves high costs and high risks

Race for Asian middle class

- Trade restricted in wealthy markets – EU, Japan and North America
- EU and North America consume more luxury and valued added dairy products, less liquid milk, but overall value is up
- Strong competition in developing markets. Focus on growing middle class in Asia and South America:
  - Still dominated by powders (reconstitution into fluid products) – traditionally low dairy demand – lactose intolerance, lack of dairy tradition, high cost of processed dairy products relative to incomes
  - But this is changing, particularly in China, with lower trade barriers in Asia and South America

Trends in value and demand

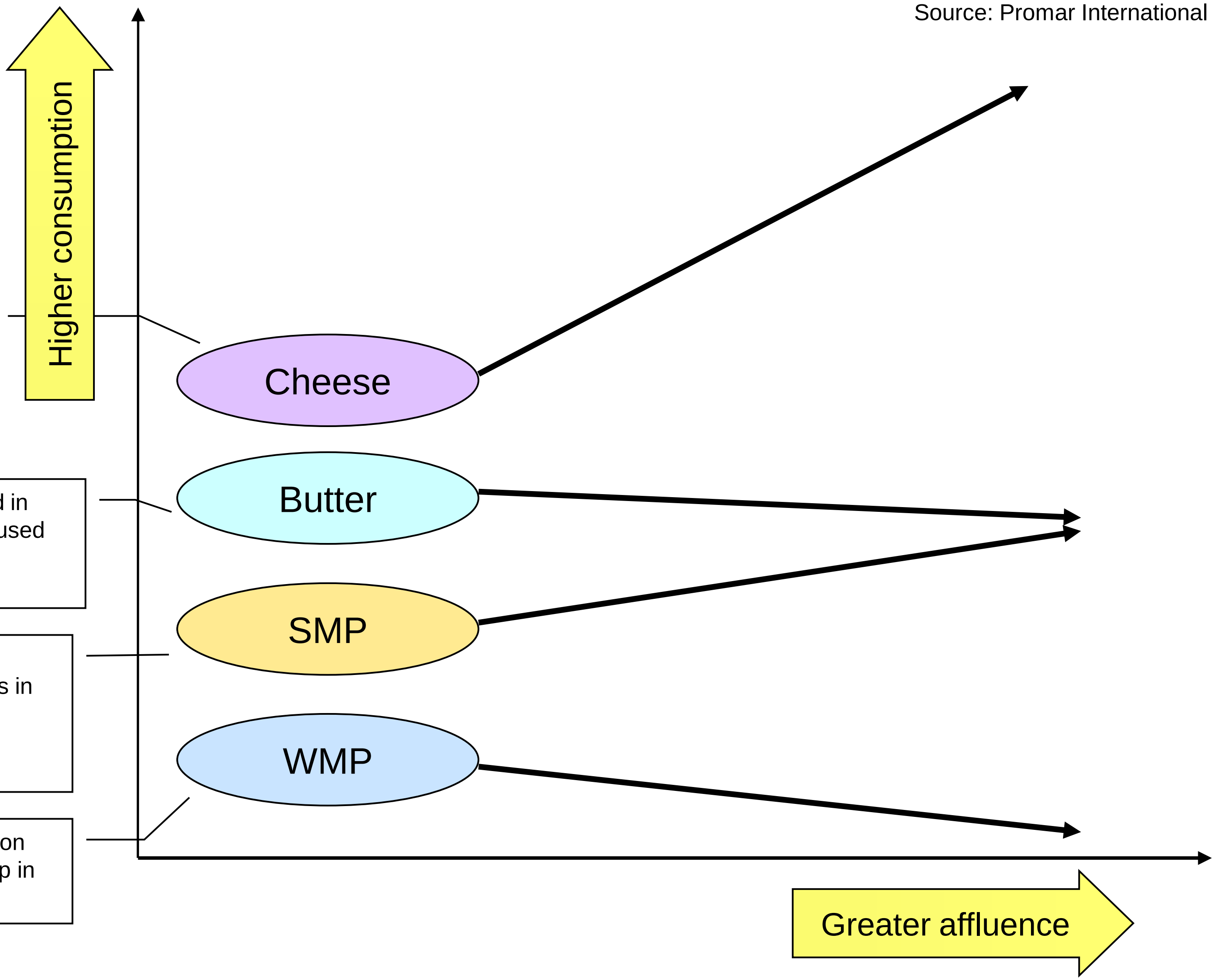
Source: Promar International

Expected to increase 25% in USA over next 15 yrs – main demand from foodservices + industrial outlets

Reduction in butter demand in affluent markets, but more used as ingredient in bakery and confectionary products

Historically used in animal feeds, but higher value uses in affluent markets now as an ingredient to yogurts, dairy desserts + some cheeses.

Used mainly for reconstitution into liquid milk products, esp in 'hot' countries



Product outlets

Retail
- Branded consumer goods
- 12 month shelf management
- Dominated in EU + USA by multinationals –
- Wal-Mart, Auchan, Royal Ahold
- Very strong purchasing strength

Suppliers needs scale and product portfolios year round – hard for dairy processors

Arla spent €20m pa on Lurpak brand in UK alone

Danone spent 5% of Fonterra's total sales on advertising and promotion in 2000 to support its brands

Industrial
- Prepackaged food
  eg sandwiches *(+45% in last 6 yrs)*
- Dairy for processing
- Food products – eg pizza *(12.4% in 6 yrs)* + bakery products

Food services
- Double growth of retail
- Ready to eat meals
- Decline of ingredients

Growing 2 times faster than retail food sales growth

Source: Promar International

Section 4:
Performance Framework

This is a further contextual section which seeks to explain the basis on which Fonterra's performance is supposed to be assessed

Gains since 2001

Since the merger of NZ Dairy Group, Kiwi and the Dairy Board in 2001 to form Fonterra, several gains have been made, in particular:

- 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)

Traditional benchmark

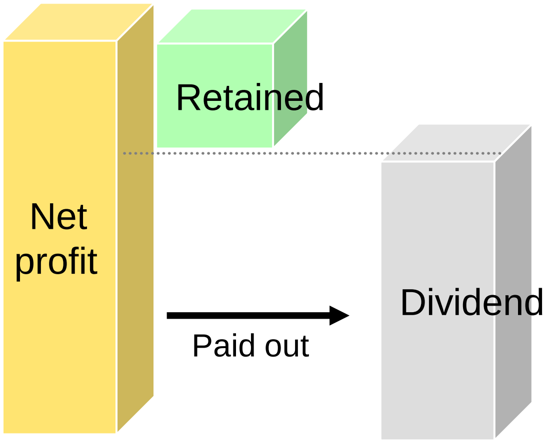
- However, the main focus of traditional producer co-ops is to maximise the price paid to suppliers for their goods. Payout is therefore the primary measure of performance
- This works for traditional producer co-ops where:
  - Suppliers have limited capital invested in the company
  - The goods supplied are homogenous
  - Goods produced do not differ markedly from the goods supplied
  - Competitive benchmarks for payout are available, and
  - Suppliers have a close connection with the co-op
- Fonterra does not meet these criteria – in particular:
  - Suppliers have considerable capital invested, and
  - Fonterra is trying to produce more differentiated products created from inputs additional to raw milk

Normal company benchmarks

- In a large widely-held company, performance is measured by growth in the value of shareholders’ investment
- Shareholder value has two components:
  - Dividends paid out, and
  - Shares’ market value

Dividend

- Dividends are normally paid from net profits. Most companies retain some of the net profit
- The dividend rate is normally set by the company and approved by the shareholders
- Dividend policy changes over time, depending on the company's capital investment programme and shareholders' expectations



Share value

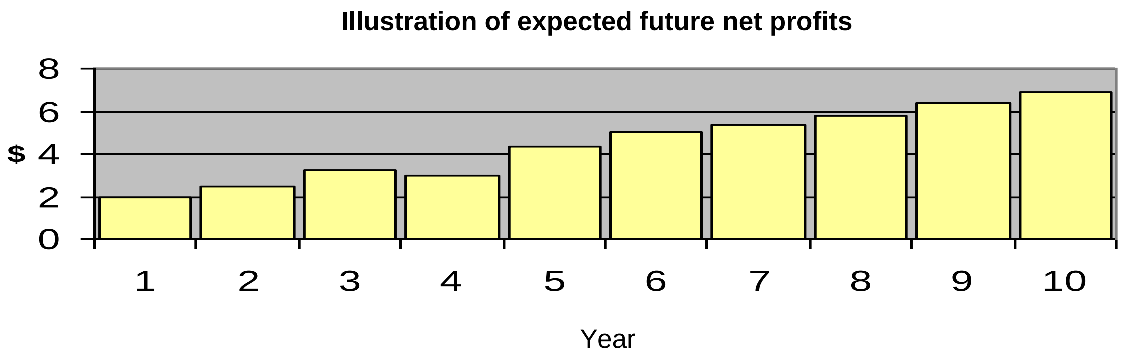
- A share's value is simply today's value of expected future net profits, looking forward several years

- Put another way, a share's value is the amount you would need to invest today, earning an appropriate interest rate (based the business' risk), to equal the expected stream of future net profits

- Shares can be valued in a variety of ways. The 'discounted cash flow' method is perhaps most common. It has three key steps, which are described on the next slide

Share value *(cont'd)*

- **Step 1**: Estimate future net profits for the next 7 – 10 years. This will depend on expected prices, volumes, exchange rates and expenses



There will be a variety of views about future profits and risk. This diversity of views is vital in establishing a robust share value

- **Step 2**: Set an interest rate based on how risky the business is relative to the Govt bond (or 'risk-free') rate

- **Step 3**: Calculate how much capital (as a lump sum) would need to be invested today at the interest rate (from Step 2) to return the expected future net profits (in Step 1). Divide the lump sum by the number of shares on issue and this is the share value

Relevance to Fonterra

- So why is this relevant to Fonterra?
- As mentioned earlier, return on capital is key because:
  - Suppliers have considerable capital invested in Fonterra, and
  - Fonterra is trying to produce more differentiated products created from inputs additional to raw milk
- It is also relevant because Fonterra has near monopoly on raw milk and dairy exports

Monopoly costs

- It is a simple fact that monopolies tend to be inefficient over time. They cause three main types of loss:
  - They use more resources than is best to deliver goods and services
  - They over or under price, which distorts how much people buy or invest, and
  - They suppress new ideas and innovation, which robs consumers, shareholders and the wider economy of new value
- It is highly likely that the NZ Dairy Board built up significant inefficiencies while monopoly exporter of NZ dairy products

Fonterra's near-monopoly

- Fonterra has, at least for the medium term, effectively taken over the NZ Dairy Board's position as the near-monopoly exporter of NZ dairy products
- In addition, Fonterra has become a near-monopoly buyer of raw milk in NZ. The previous benchmarks of at least two large processors ended with formation of Fonterra in 2001
- The risk of monopoly inefficiencies was acknowledged in forming Fonterra. If this key risk could not be effectively managed, McKinsey (a key industry adviser) preferred the option of two competing dairy exporters

Fonterra’s new benchmarks

- With a view to mitigating the real problems of a monopoly cooperative bundling returns to suppliers, Fonterra (and its predecessor, the NZ Dairy Board) developed a new set of performance benchmarks

- These new benchmarks seek to proxy those used by normal large companies (described earlier), namely:

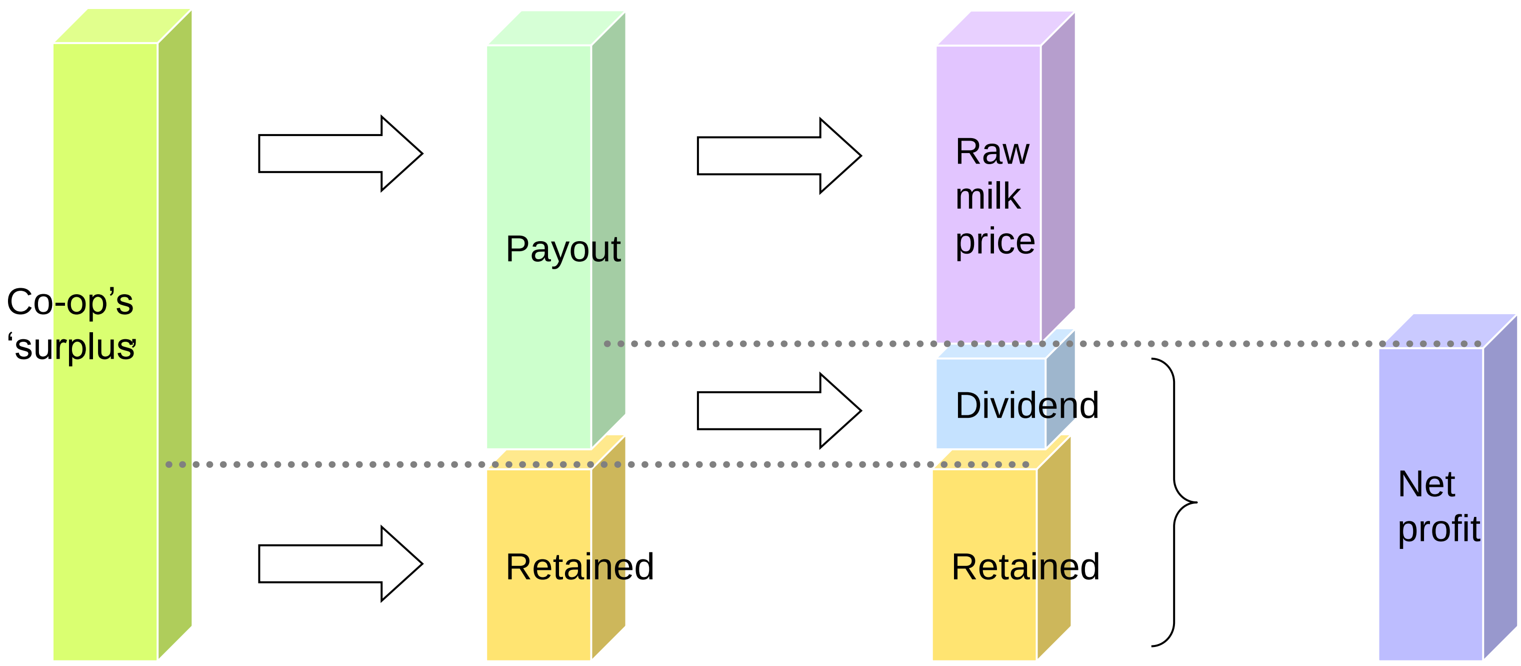
Return on investment = dividend + change in share value

- While farmers continue to focus mainly on payout, Fonterra is now supposedly focused on delivering an appropriate rate of return on shareholders’ investment. This is likely to cause some confusion

Core 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’



No raw milk market

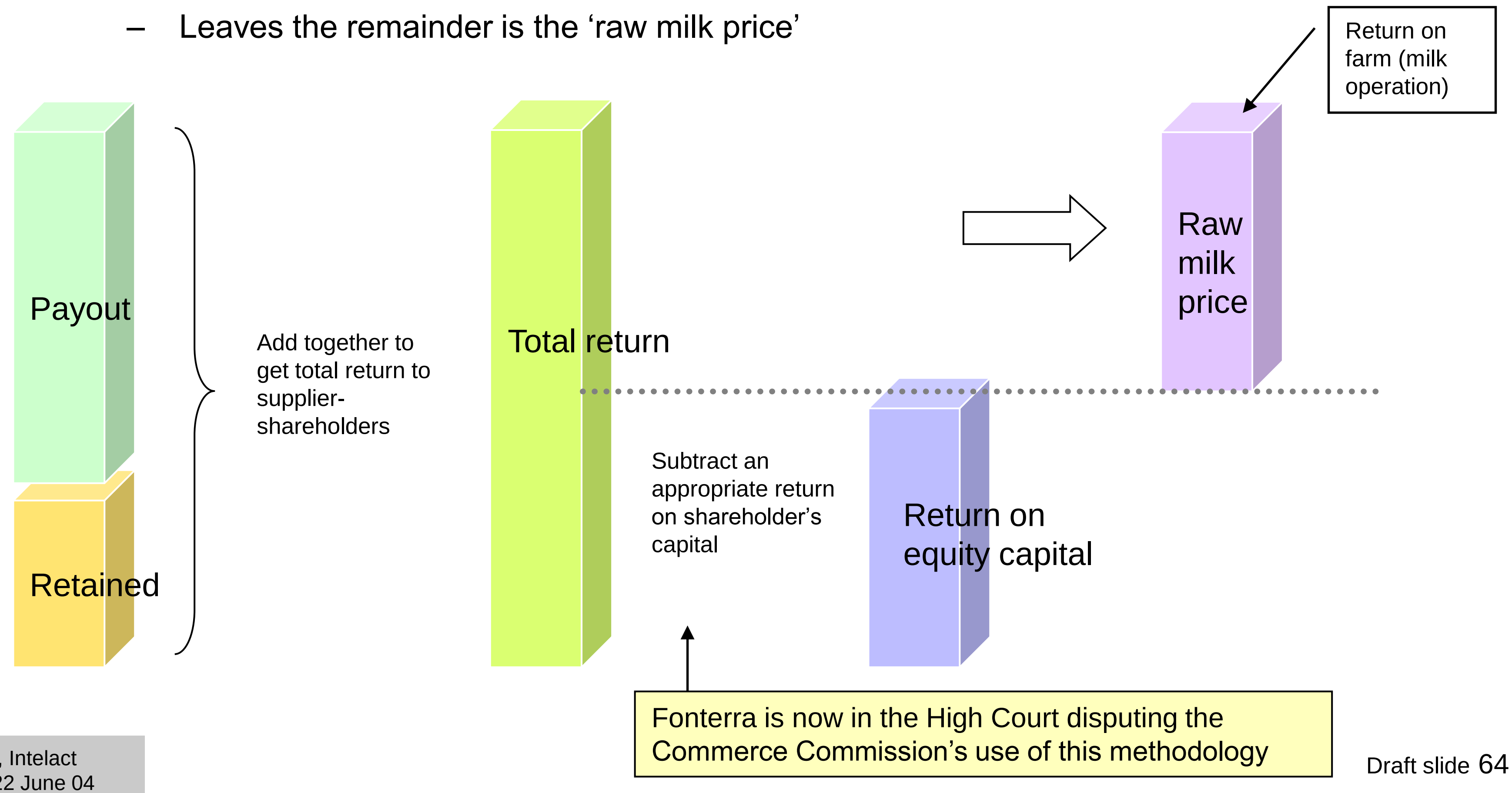
- If there was a real market for raw milk, the split would be straightforward. However, over many years, political and cooperative control effectively eliminated the raw milk market in NZ
- The split now is therefore somewhat artificial
- Separating milk price from net profit is less important if:
  - suppliers do not have significant capital invested in the cooperative, and
  - the cooperative only sells low level commodity products made only from suppliers' milk. (If this was so, there would be less need to separately measure returns on capital and other activities)
- However, Fonterra's suppliers have considerable capital tied up in Fonterra, *and* Fonterra aims to convert milk into highly differentiated products using other inputs, not simply NZ milk – so return on shareholders' capital is extremely important

Caveat

In the following slides, I have tried to distil my understanding of Fonterra’s performance measurement regime in a reasonably clear manner. Some details have been omitted

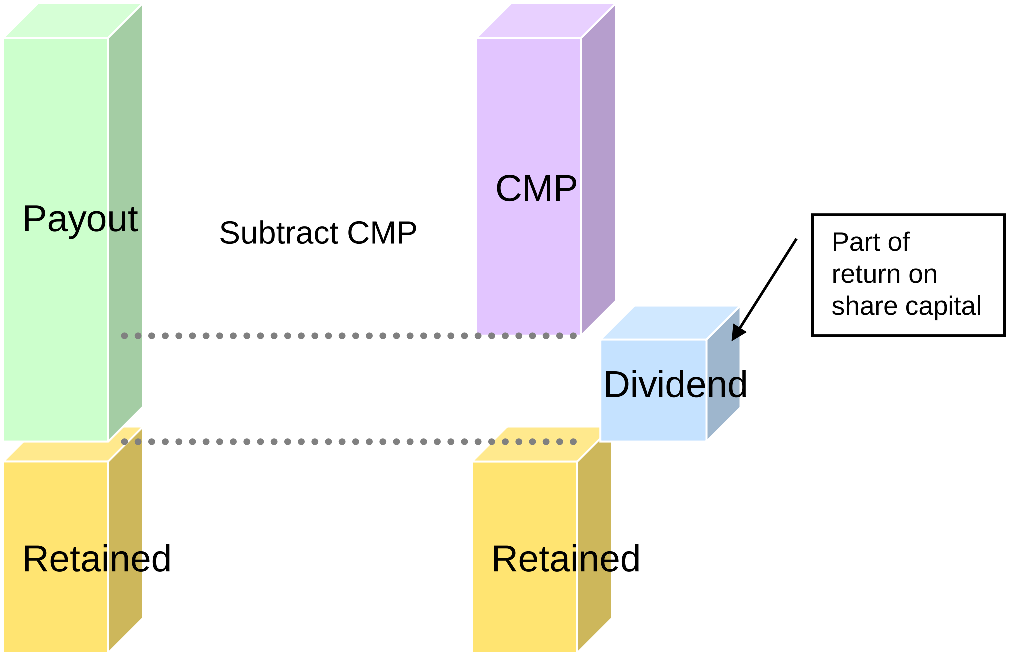
Milk price: method 1

- Under the 'Raw Milk' Regulations 2001, the Commerce Commission:
  - Adds together the 'payout' + 'retentions'
  - Then separates out an appropriate return on shareholders' capital
  - Leaves the remainder is the 'raw milk price'



Milk price: method 2

- Under the second method:
  - An ‘independent’ person sets the ‘Commodity Milk Price’ (CMP), the price a hypothetical efficient processor would pay
  - CMP is then deducted from the ‘payout’
  - The difference between ‘retained’ and CMP is the ‘dividend’ (Fonterra calls it the ‘value added component’)

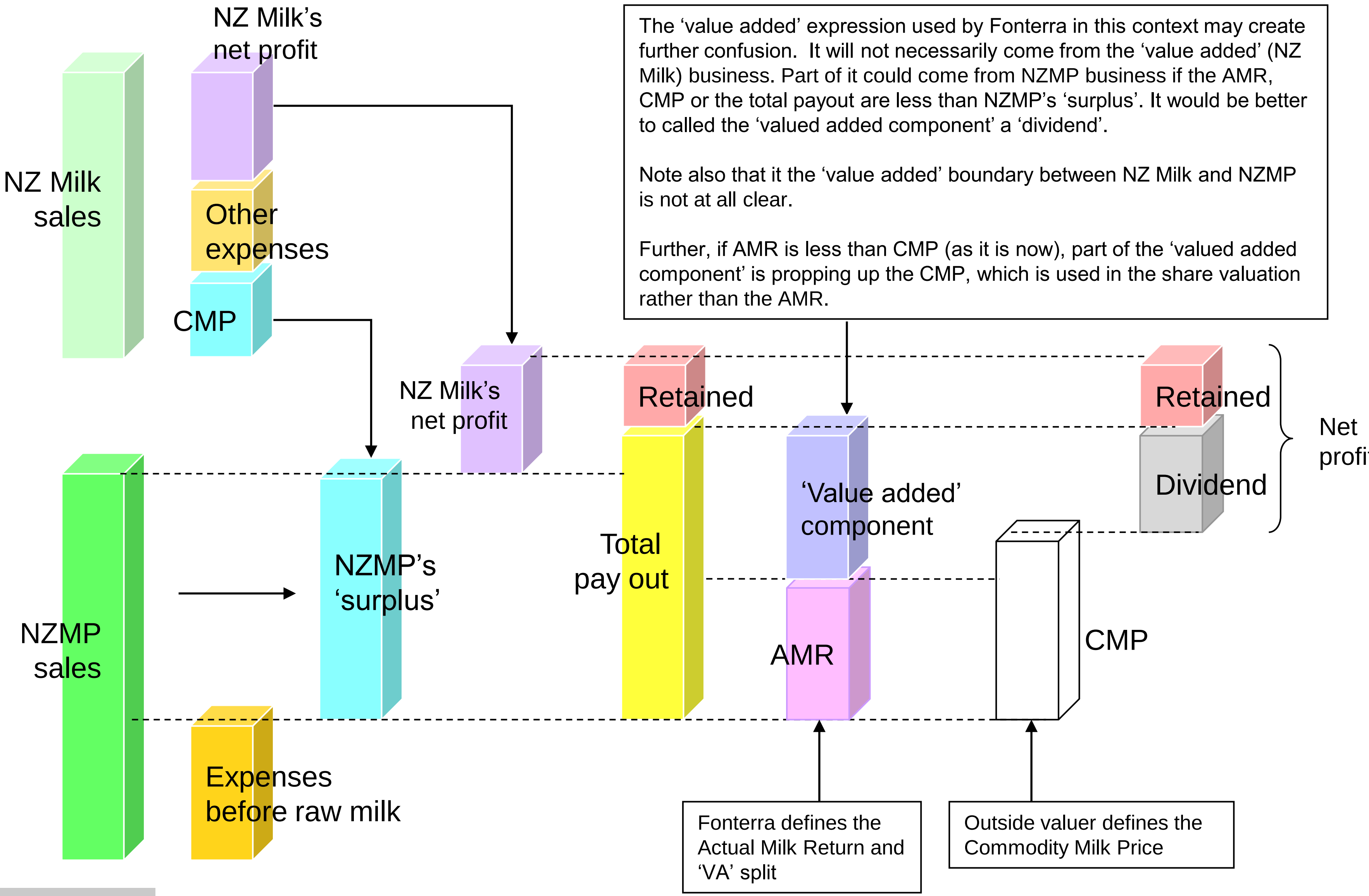


Fonterra's overall business

The 'value added' expression used by Fonterra in this context may create further confusion. It will not necessarily come from the 'value added' (NZ Milk) business. Part of it could come from NZMP business if the AMR, CMP or the total payout are less than NZMP's 'surplus'. It would be better to called the 'valued added component' a 'dividend'.

Note also that it the 'value added' boundary between NZ Milk and NZMP is not at all clear.

Further, if AMR is less than CMP (as it is now), part of the 'valued added component' is propping up the CMP, which is used in the share valuation rather than the AMR.



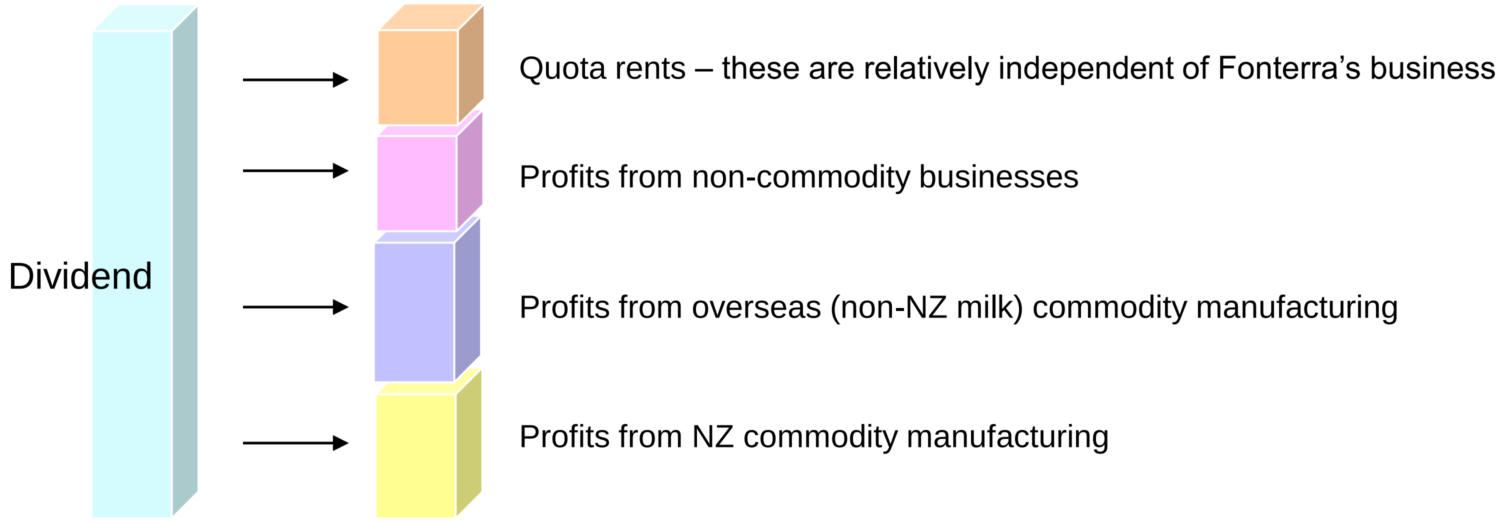
[Not to scale]

Dividend components

The ‘dividend’ (or what Fonterra calls the ‘value added component’) bundles together several items.

An increase in any of these items should *not* be seen by NZ farmers as a signal that additional income can be achieved by increasing production.

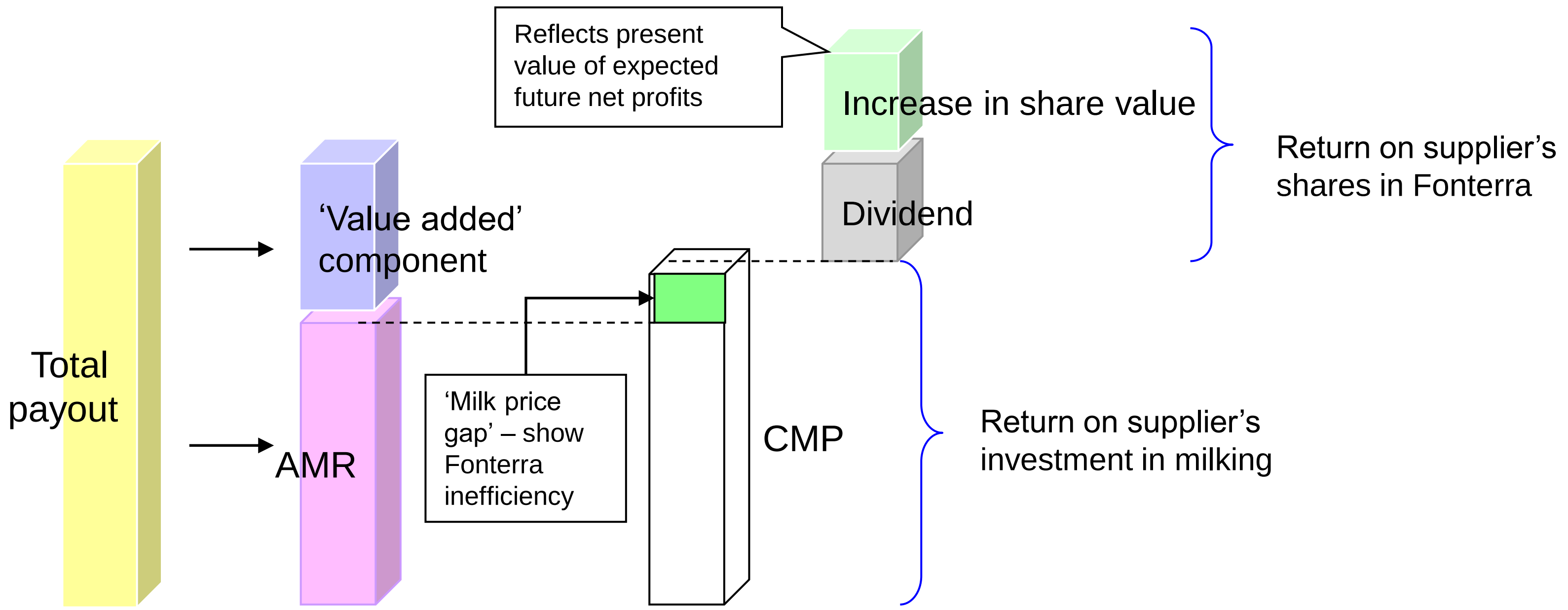
The aim of ‘unbundling’ is to disconnect milk production from non-commodity value creation. It is not clear this has been achieved.



[Not to scale]

Relevant to farmers

- For Fonterra's regime to work in practice, farmers need to understand these key steps:
  - First split the total payout into AMR and 'value added'
  - Then adjust the 'value added component' (by subtracting the gap between CMP and AMR)
  - Then take the adjusted 'value added component' (or dividend) and add it to the change in share value
  - Then make investment decisions based each 'unbundled' set of returns



Limitations

- In essence, a closed supplier cooperative is trying to measure itself like an ‘investor-owned firm’
- This is inherently difficult to do, especially when there is no competitive market for suppliers’ product
- Fonterra’s framework overall is somewhat contrived and strained, particularly as it runs counter the incentives created by Fonterra’s current structure
- Another problem is that the methodology has some internal circularity, making some results self-validating
- It is also highly administered. Valuations of CMP and Fonterra’s shares reflect the views of one valuer, not a diversity of people with different views on potential future value and risk. Minor changes in some assumptions could have significant impact on projected values

Limitations *(cont'd)*

- In practice, suppliers still receive one 'bundled' payment. They do not receive the Commodity Milk Price (CMP)
- Most farmers and Fonterra in public still focus on the size of the overall payout as the key measure of success
- Few farmers are likely to distinguish between:
  - Actual Milk Price (AMR) and CMP
  - CMP and 'dividend', or
  - AMR (being a farmer's actual return on milk) and Total Shareholder Return (being a farmer's return on shares invested in Fonterra)
- Unless farmers used it in their investment decisions, the new measurement framework is not likely to be effective. It is unlikely that many farmers understand it

Farm profitability

"Few farms cover their full economic costs (land, labour, capital and opportunity costs)."

"The larger NZ farm [in the study] generates a good return to family labour but the smaller 225-cow farm is not able to deliver the average hourly wage rate to its family"

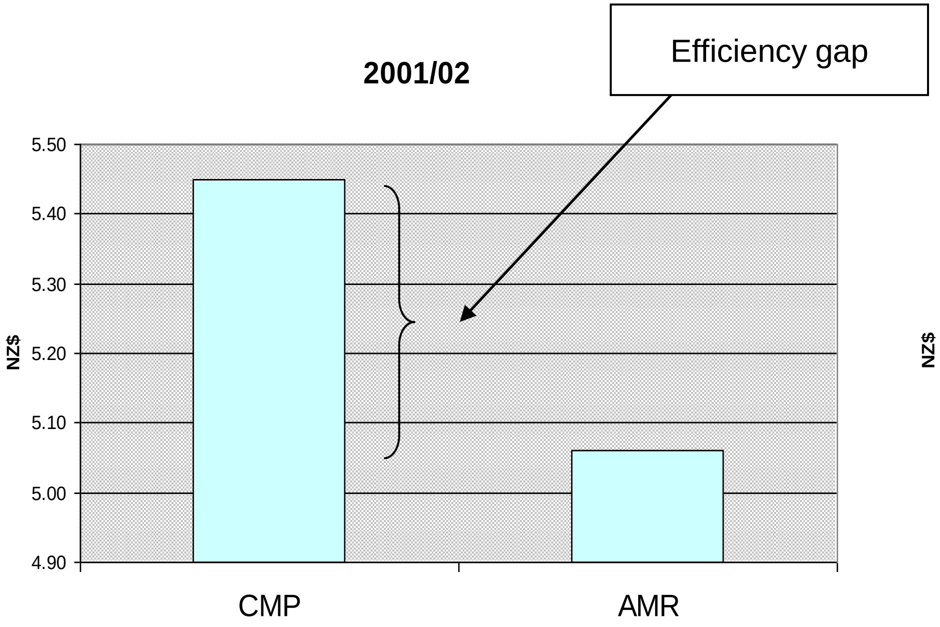
"The profitability of NZ dairy farmers, on average, could be classed as **uncomfortably low** in the competitive world dairy environment"

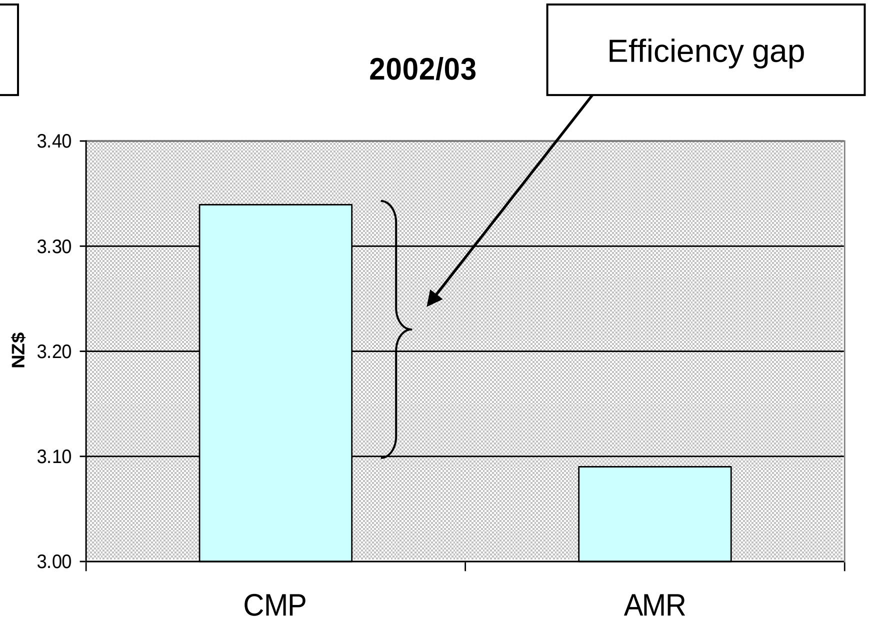
Nicola Shadbolt, Massey University, 2002

Fonterra's efficiency gap

CMP = Commodity Milk Price – the milk price a fully efficient processor would pay

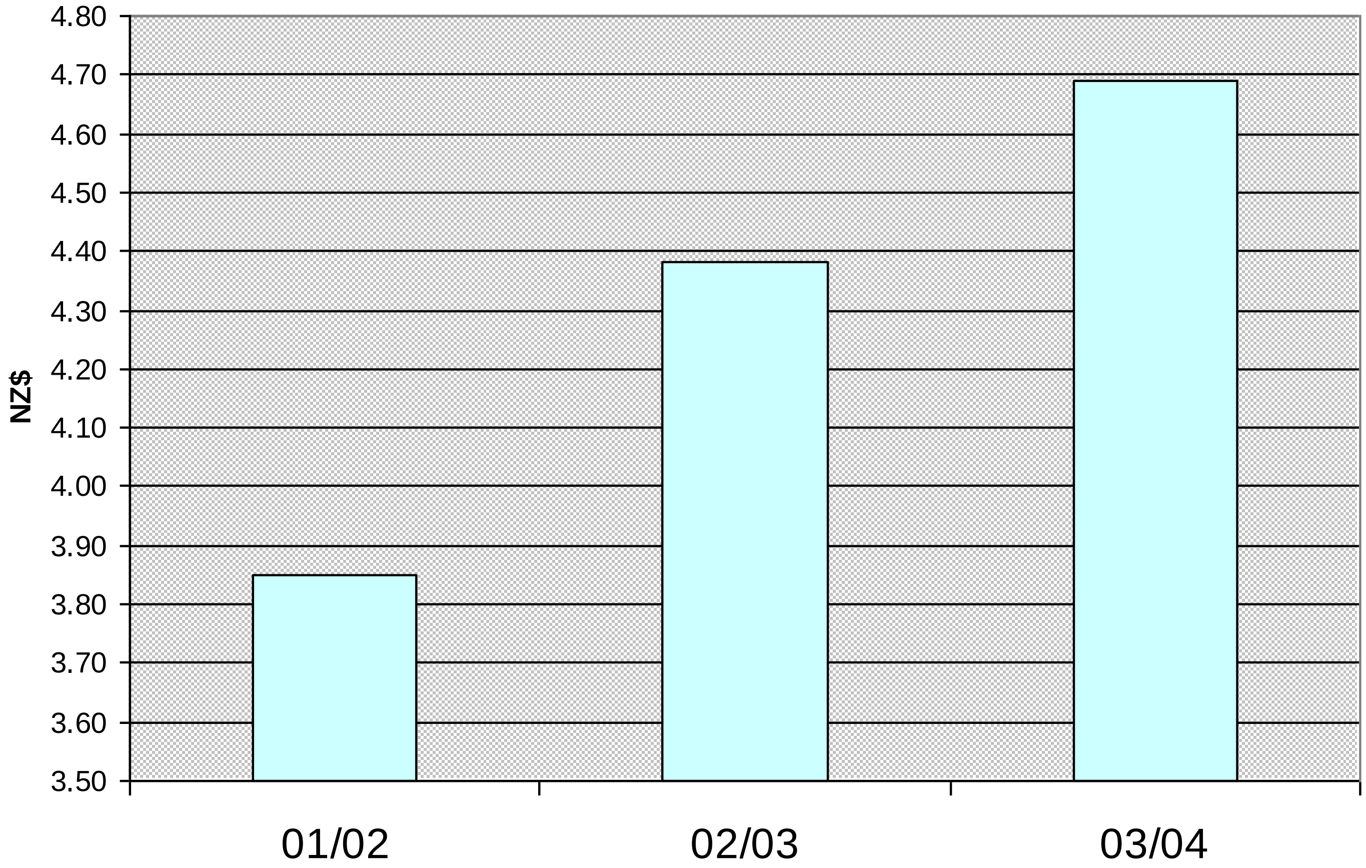
AMR = Actual Milk Return, which is the milk price paid by Fonterra





Fonterra's share value

The 'fair value' is set each year by Fonterra working within a valuation range determined by a valuer (Standard & Poors) engaged by Fonterra



Section 5:
Problem of Multiple Objectives

Need clear primary objective

- The primary objective of most companies is to maximise the value of shareholders' investment over time. It is simple and provides a clear point of reference for directors in making trade-offs between competing potential outcomes
- It also provides a clear framework for the company in developing strategies to achieve this objective
- Clarity of the paramount objective is crucial for effective corporate governance

> "It is logically impossible to maximize in more than one dimension at the same time….Thus, telling a manager to maximize current profits, market share, future growth in profits, and anything else one pleases will leave that manager with no way to make a reasoned decision. In effect, it leaves the manager with no objective. The result will be confusion and a lack of purpose that will handicap the firm in its competition for survival….."
>
> "[Multiple objectives] politicise a company and leave its managers empowered to exercise their own preferences in spending the firm's resources"
>
> **Prof Michael Jensen**, Harvard Business School, *"Value Maximisation, Stakeholder Theory and the Corporate Objective Function",* Journal of Applied Corporate Finance, Vol 14, No. 3, Fall 2001 at p10.

Fonterra’s objective not clear

- Fonterra has a range of objectives – some commercial, some social. It also has a range of views about what sort business it is
- These are set out in various documents, including Fonterra’s constitution, its 2002 strategy, its Cooperative Philosophy Statement and various presentations
- Shareholders’ paramount objective has been to ensure that the NZ industry continues –
  - to be owned and controlled exclusively by NZ dairy farmers
  - in a cooperative structure following cooperative principles
- Key cooperative principles include:
  - maintaining cooperative culture
  - accepting all shareholders’ milk, and
  - informing, educating and consulting

Wealth creation or distribution?

- It is also interesting that Fonterra's Cooperative Philosophy Statement emphasises the distribution of wealth:

> "At the heart of the Cooperative Philosophy is the <u>distribution</u> of wealth between shareholders"

- There is a real tension in many supplier cooperatives between creating wealth and sharing it

- Many supplier cooperatives get stuck in a knot because members say –

> No to proposals that grow value <u>unless</u> –
> - Suppliers keep total control
> - No outsider investors take a share, and
> - Benefits are shared equally among all suppliers

- The upshot is that suppliers own 100% of $100, when they would be better off owning 50% of $1,000 – but miss out because they are limited by old fears and prejudices

Milk price or return on capital?

- Fonterra's Cooperative Philosophy Statement also declares that:

> "Fonterra's principle purpose and priority focus is to maximise the sustainable value of *supplying* shareholders' milk…Payout is of primary importance to meeting supplying shareholders' needs"

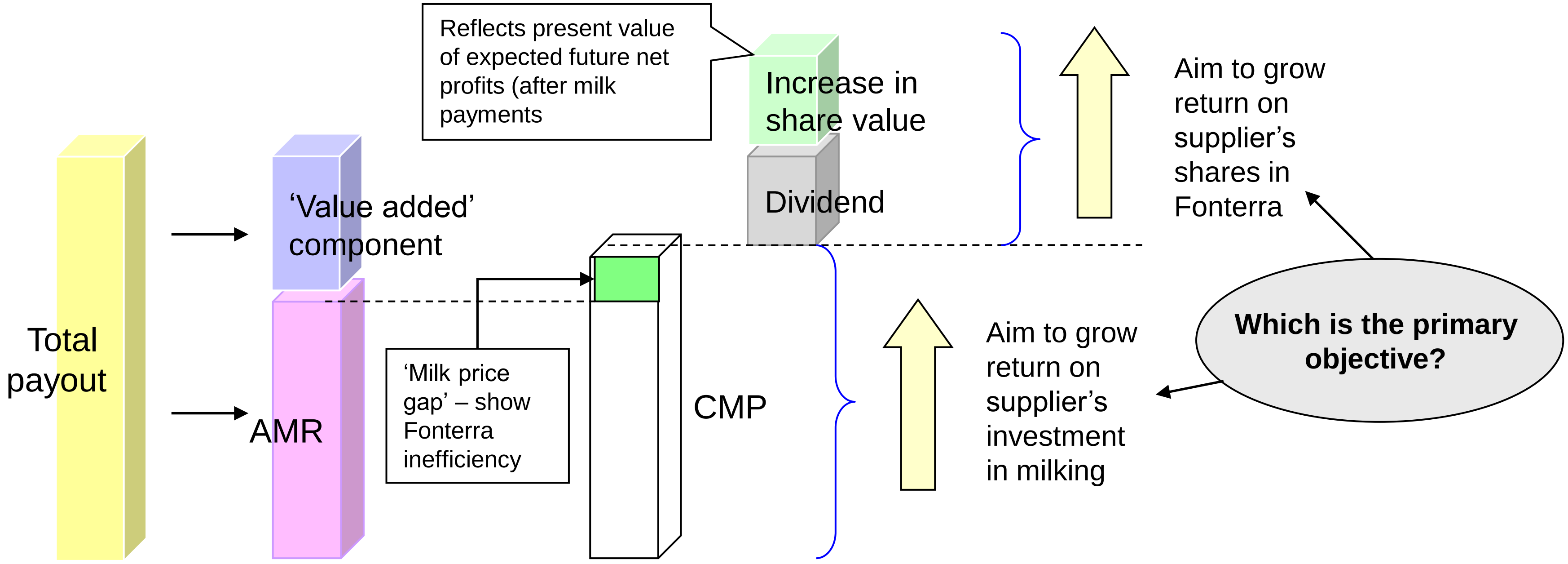
- So what is the priority: growing milk price (traditional 'payout') or growing returns on a larger base of shareholders' capital?

- Fonterra's position is not clear. Yet the two objectives are quite different, steering in radically different strategic directions

- Fonterra was ostensibly formed to deliver improved returns on a significantly enlarged capital base, using non-supplier capital to help underwrite major growth in non-commodity (higher margin) businesses

There is a conflict

- Is the primary aim to grow the raw milk price or return on shares?



Strategic implications

- Aiming to grow the milk price drives on focus on more cost-savings, a continuing production-push for more milk, more processing plant, larger peaks, seasonal customer service, more commodities and competing in emerging markets
- Aiming to grow returns on shares drives a focus on controlling the flow milk (by fixed volume contracts and price) to better match assets and customer demand, focusing on customer needs to identify new value opportunities, spreading risk through diversification and raising new capital where appropriate
- Either approach may be rational. However the case has not been made by Fonterra one way or the other
- The current position is a muddle, with industry leaders claiming in effect to have ‘a bob each way’. This lack of clarity is likely to be causing significant loss of value for shareholders and the economy. It is a hiatus that has impaired the industry for the last 10 years at least

Overseas milk

- Fonterra's Cooperative Philosophy Statement also focuses on NZ milk. How does Fonterra's push to develop overseas milk processing fit in? Who pays and who carries the risks relating to overseas milk?

- NZ suppliers are given no choice in relation to investing in downstream businesses, including processing overseas milk. It is a compulsory and growing investment.

- One analyst has observed that returns from this compulsory investments are likely to be lower than from alternative investments:

  – Suppliers are likely to get higher return from investing in their own businesses where capital is combined with own expertise and they incur minimal monitoring costs to ensure its efficient use;

  – Because Fonterra obtains share capital without having to compete in the capital market, it has less incentive to use funds to return maximum yields over time; and

  – 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

Structure follows strategy

- Fonterra's key strategy executive, Graham Stuart, viewed Fonterra in 2002 as three things:
  - "We are a dairy farmers' co-operative.
  - And we are a multinational marketing company.
  - And we are also an international capital investor"
- As noted earlier, this multi-faced (many things to many people) approach is unlikely to achieve any objectives well
- As suppliers of raw product (milk) and large scale investors (value-adding), Fonterra's shareholders have two distinct business interests. A different strategy and structure is required for each

Key issue 6:
Fonterra's Strategy

Key components

- Fonterra's current strategy (issued in 2002) – 'the Seven Pillars' – is not significantly different from the 1999 mega co-op strategy. Fonterra's main business goals are to be:
  - The lowest cost supplier of commodity dairy products
  - The leading price and inventory manager in global commodity markets
  - A developer of dairy ingredient partnerships
  - A leading specialty milk components innovator and solutions provider
  - A leader in consumer nutritional milks
  - A leading dairy marketer to foodservices in key markets

……And to integrate strategies for China, South America, India and Eastern Europe

Specific targets

- Fonterra's specific targets include at least 15% Total Shareholder Returns (TSR)
  - In 2002, Graham Stuart said Fonterra would have to outperform the Commodity Milk Price by 30% in order to achieve the 15% TSR
- Other target were:
  - To grow revenues by 15% every year
  - To deliver 4% real productivity gains every year across the value-chain
- These remain challenging targets for Fonterra to achieve

Commodities strategy

- While NZ is no longer the lowest cost producer, Fonterra continues to be 'pushed' by an ever increasing production of raw milk. Its focus is therefore necessarily heavily weighted toward processing and (to use Warren Larsen's words) "finding a home" for its commodity products
- On-going productivity improvements are essential. But it is probably a cycle of diminishing returns. NZ's 'natural' competitive advantage – low cost feed – is being eroded by genetics and biotechnology
- In commodities, Fonterra is *"sprinting to stand still"*

Idea of 'value adding'

- For the last 15 years, successive Dairy Board leaders have asserted that the NZ industry's primary goal is "to move up the value chain", "to covert to value added", "to capture the full value of milk"

- In 1989, Sir Dryden Spring said the Dairy Board's core strategy for the 1990s is "to lift the 30or 40% of milk which is sold as value-added products to as close to 100% as we can get as soon as possible"

- In 1997, Warren Larsen said: "Finding a home for so much extra product has been a major challenge…..But simply 'finding homes' for product is not what we are in business of doing. Our aim is to develop high value branded or specialised products and take them into positions of market leadership…Higher returns will not be won by simply producing and processing more milk. They can be achieved through minimising our dependency on commodity sales and placing the value-added products our industry makes so well in the market sectors offering the highest returns…"

- In 2003, Craig Norgate said: "We need to use our superb knowledge of milk to develop innovative specialty dairy products. This effort will address the needs of the most sophisticated ingredients consumers [sic] in a manner similar to what Tatua has done, with great success"

Poor results

- In practice, the 'strategy' has been unclear and, where tried, produced rather indifferent results
- It is now clear that between 1995 and 1999, the Dairy Board's forays into consumer markets were largely unprofitable. Most products made losses. Only powders did ok
- Several specialty products were particularly unsuccessful
- Returns from Fonterra's consumer arm (NZ Milk) are also relatively poor
- However, this is not entirely surprising. The success rate for specialised consumer dairy products is not high. It requires considerable R&D, marketing expertise, luck and a large amount of capital to sustain a process of innovation in these markets

Driven by production

- Fonterra's consumer arm claims to have developed 180 new products over the 2000 – 2002 seasons, and two new products a week in 2003 season

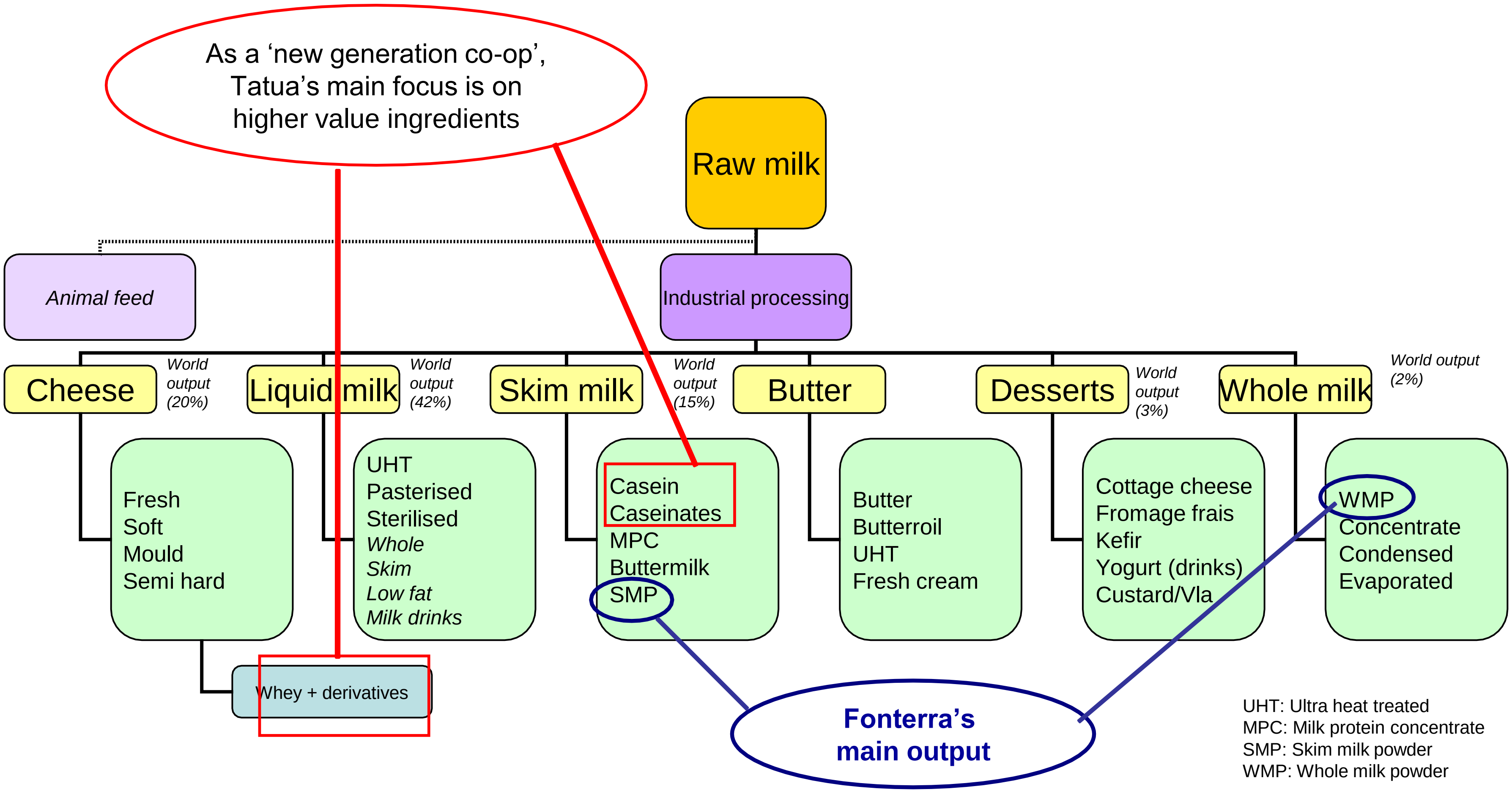
- But despite repeated promises of "moving to value added", Fonterra (like the Dairy Board) is largely driven by increasing milk production. It tends to dwarf its efforts to build a higher margin businesses

- This problem is not unique to NZ. As Promar International pointed out:

  "The North American market is divided: cooperative processors concentrating on commodity and fresh milk products (low value/low margin end), while corporate companies (Kraft and others) are developing greater market presence in add value consumer foods.

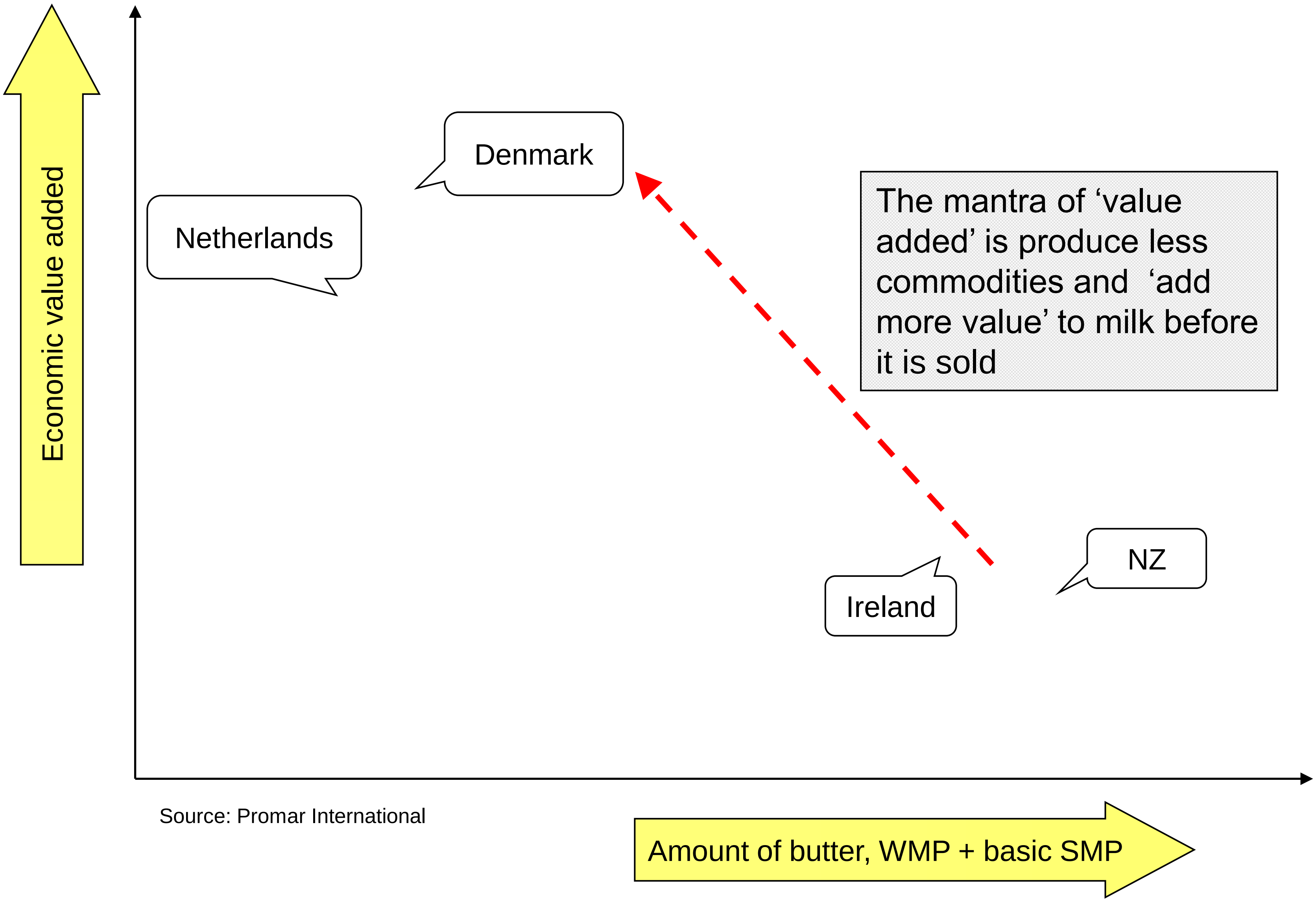
  This reflects stakeholder preferences: co-ops are required to shift large volumes of milk for their supplier shareholders, while corporate processors are concerned with maximising value, not necessarily volume" – Promar, 2001

Products from raw milk



Sources: Rabobank, FAOSTAT

'Value adding' strategy



Source: Promar International

Case of higher value?

- However, Fonterra has yet to set out its case for investing significantly more capital in non-commodity products
- In many quarters, moving to higher margin businesses is simply accepted as self-evidently logical from a business perspective
- It is not. The case needs to be made weighing:
  - Risks
  - Expected returns
  - Returns from alternative uses of the capital required
  - Impacts on other parts of Fonterra's business, and
  - Competency to deliver

Specialised ingredients

- On its formation, Fonterra was advised to develop a major specialised ingredients business focusing on:
  - Casein – TMP, casein phospho-peptide, high clarity acid casein
  - Whey – alamin, WGC, WPI, hydrolysate, alacen 845 and WPI
- Denis Brosnan, Kerry Group's recently retired (highly successful) CEO, viewed the food ingredients sector is somewhere between food engineering and pharmaceutical applications. It is 'high tech' and requires considerable R&D
- Tatua's ingredients business focuses on precise protein products, such as caseinates, whey protein concentrates, hydraulisates and biologically-active lactoferrin

Other opportunities

- A range of other non-commodity opportunities will also be open to Fonterra
- The core questions are:
  - Is there a compelling business case for investing new capital in these areas?
  - If so, where will the capital and expertise come from?
  - What governance structure is required to ensure economic efficiency?
  - Is there an alternative use of the capital with a better risk/return profile?

Key issue 7:
Fonterra's Capital Structure

Five different instruments

- For a cooperative, Fonterra has a complex share structure consisting of:
  - Fair value shares
  - Peak notes
  - Capital notes
  - Redeemable preference shares
  - Supply redemption shares

Key problems

- Fonterra is facing three risk in relation to its capital structure:
  - Redemption risk
  - Compulsory investment risk
  - Insufficient shareholder funds
  - Inefficient governance structure

Redemption risk

- This is the risk of many suppliers withdrawing at the same time, draining Fonterra's funds:
  - 400 withdrawals this year
  - This could increase if higher returns can be achieved from alternative land use (cropping, sheep + beef, lifestyle blocks) or alternative financial investments
- Redemption risk is not just a threat to Fonterra's capital base. It also involves loss of milk volumes required to cover fixed asset costs
- Over time, there is some risk of 'regional cherry picking' – new boutique processors luring preferred farmers with higher milk prices
- "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)

Redemption risk *(cont'd)*

- Several safeguards have been built in to try to protect Fonterra against a 'run funds' from many suppliers withdrawing at the same time. For example Fonterra may pay suppliers with capital notes or redeemable preference shares
- Tatua has reduced this redemption risk by creating shares called 'Milk Supply Entitlements', which may be traded among members (in proportion to supply)
- Fonterra should allow suppliers to own share within a range of their milk supply, not in exact proportion (eg within + or - 15% of milk supply)
- Allowing suppliers to buy and sell shares with other suppliers within this range would:
  - Provide greater financial stability for Fonterra
  - Improve the reliability of the share valuation, and
  - Provide an on-going signal of Fonterra's performance

Compulsory investment

- NZ suppliers are forced to invest in non-NZ milk or non-processing activities. As noted earlier:
  - Suppliers are likely to get higher returns from investing in their own businesses where capital is combined with own expertise and they incur minimal monitoring costs to ensure its efficient use
  - 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, and
  - 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 share capital

"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

- In short, Fonterra needs more share capital
- Its only options at present are:
  - Retentions, which were low for the last financial year (it is hard to retain in the face of an otherwise low payout);
  - Shares purchased to supply more milk; and
  - Inviting existing shareholders to subscribe more capital
- On a capped base of 13,000 suppliers, this will not generate sufficient capital to fund Fonterra's objectives

Global problem

- Fonterra is not the only dairy cooperative facing this problem. It is common to many traditional supplier cooperatives around the world

- Jens Bigum, the CEO of Arla Foods (larger than Fonterra) said in January 2004:

  "The dairy sector is seeing an extremely tough elimination race, and we find ourselves competing against global giants like Nestle and Danone, which a very strong capital base. In order to survive and to pay one of Europe's highest milk prices, we need a *substantial amount* equity capital".

- So far, Arla has merged with MD of Sweden and Express Dairies in the UK to achieve a large scale

1999 Plan

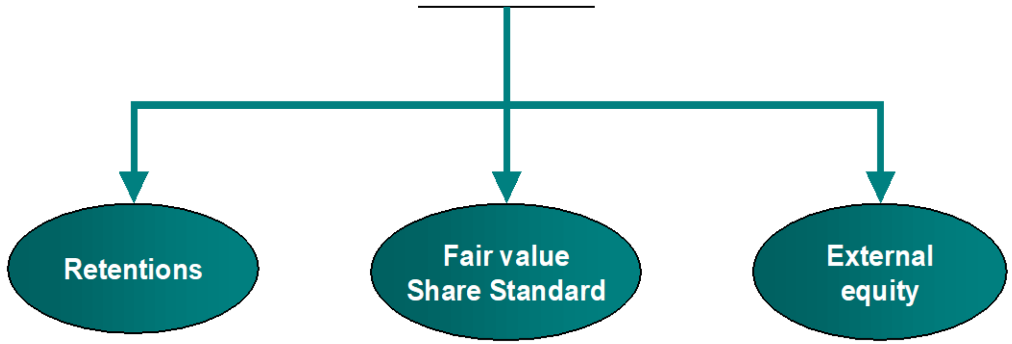
The 1999 mega-coop plan included raising an additional $4 billion in shareholder funds – some of it from outside investors

Exhibit 4

CAPITAL REQUIREMENTS AND SOURCES

NZ$ Billions

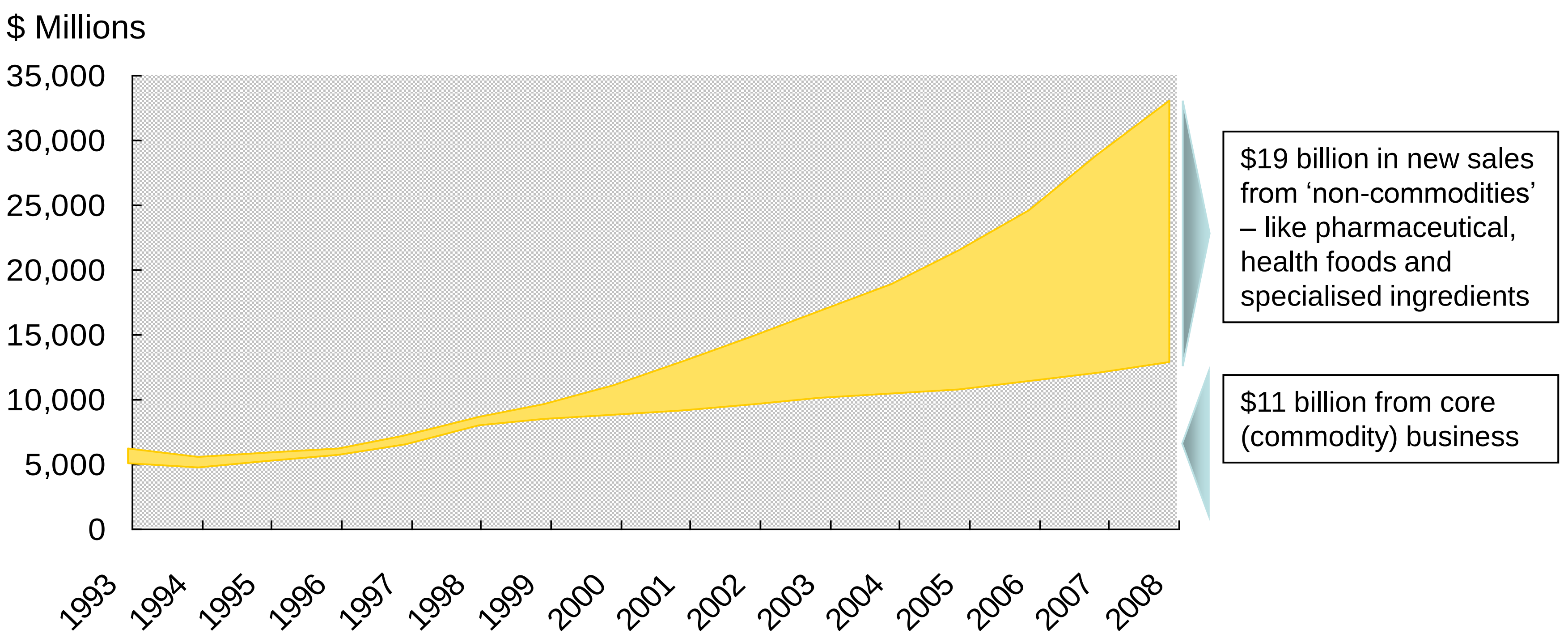
Total capital required	12
Less debt capacity	8
Additional capital required	**4**



Source: McKinsey

To fund growth

The additional $4 billion in share capital was to fund growth in various non-commodity activities



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…."

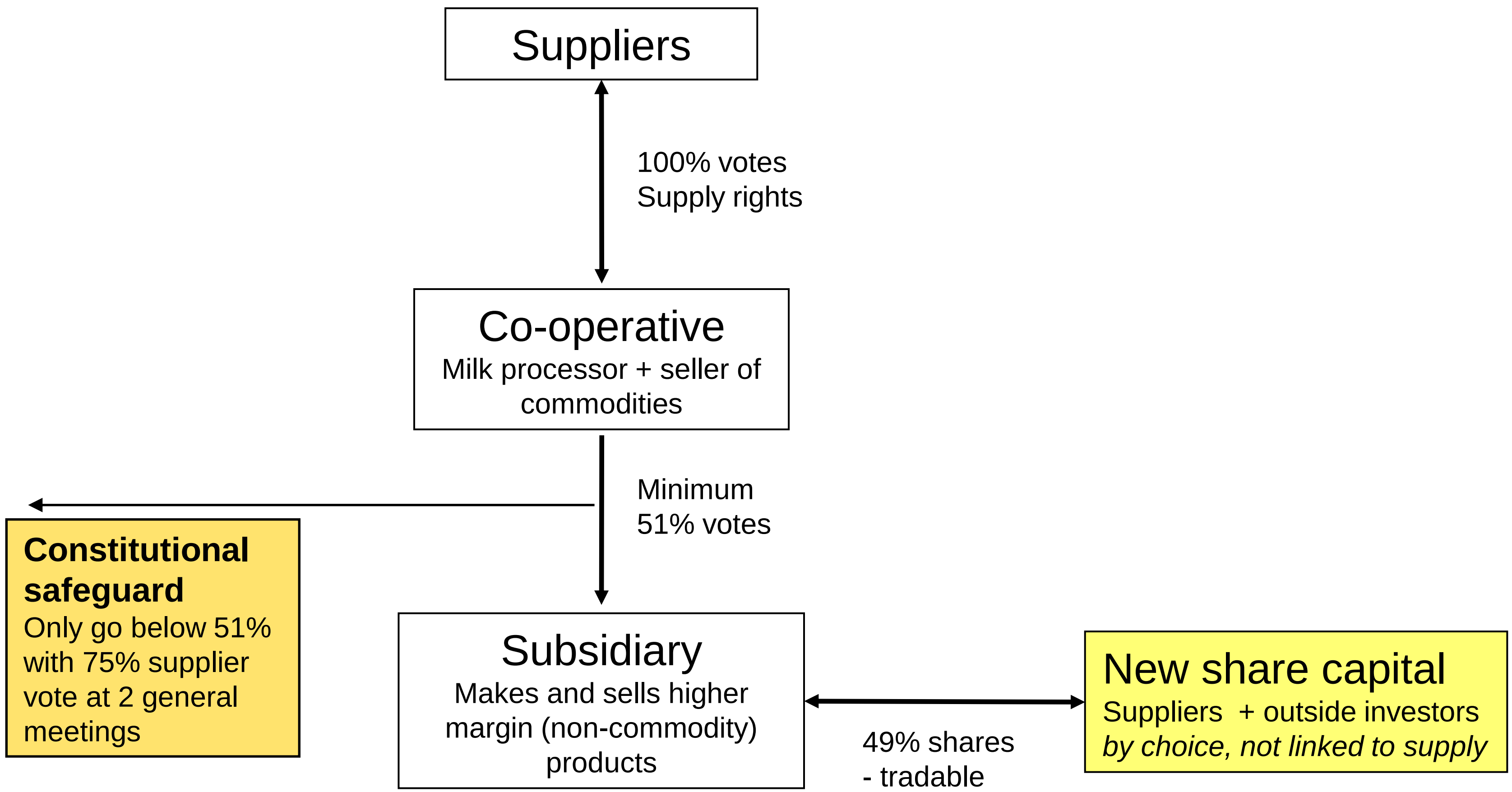
Joint ventures

- To date, Fonterra has relied on JVs, partnerships and 'strategic alliances' to get around its lack of share capital. These include:
  - Britannia in India
  - DairyConcepts, with Dairy Farmers of America, and
  - The alliance with Nestle, for the Americas

Options

- How can Fonterra bring in more share capital? It has several options, including:
  - 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
- Each option has particular pros and cons, which need to be explored in a separate presentation

Separate subsidiary



Co-op with outside shareholders

Suppliers

'A' class shares
- Supply rights
- 100% votes on key issues

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

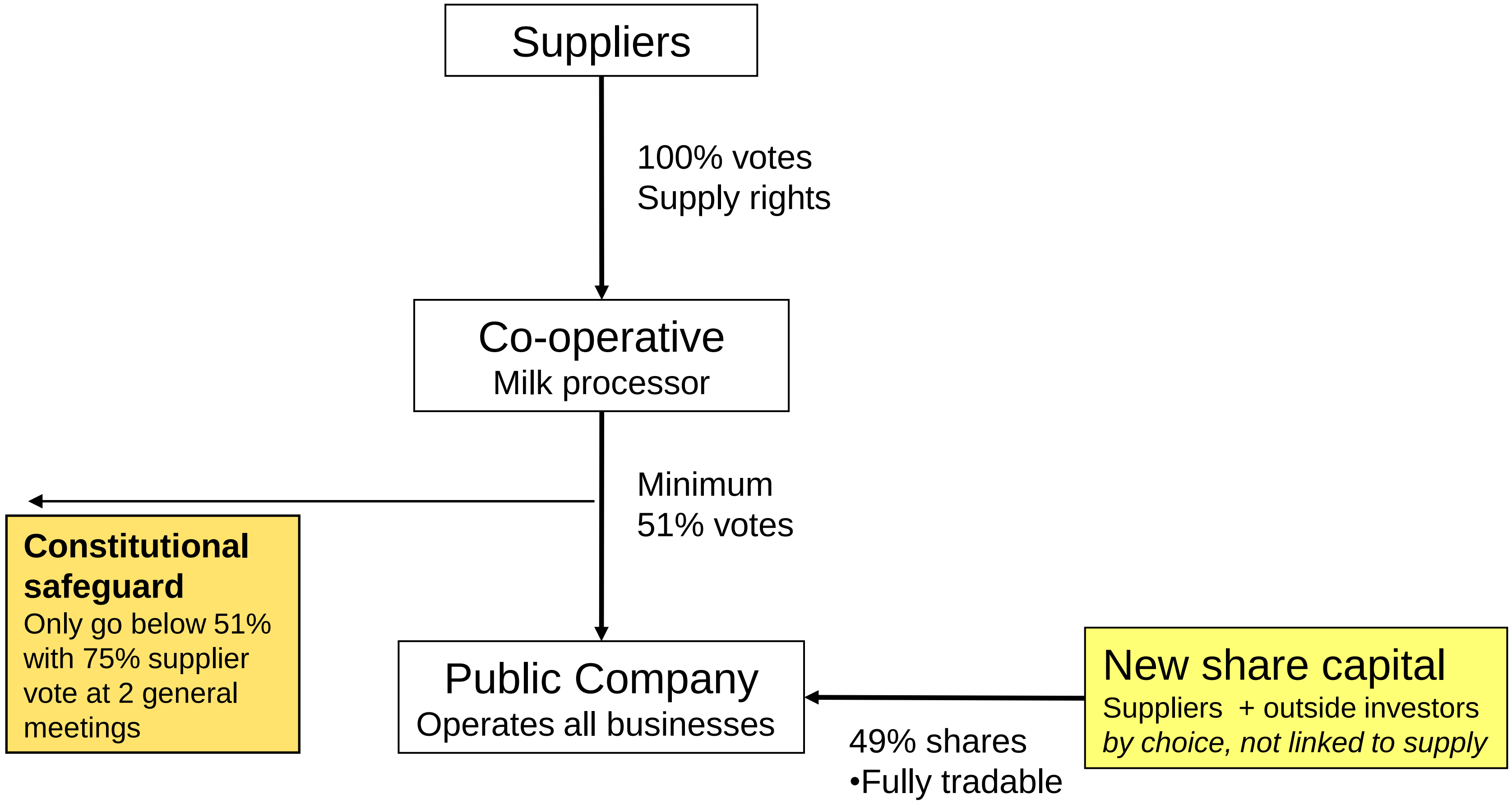
Co-operative
Milk processor + seller of commodities

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

'B' class shares
- Tradable
- Restricted voting rights

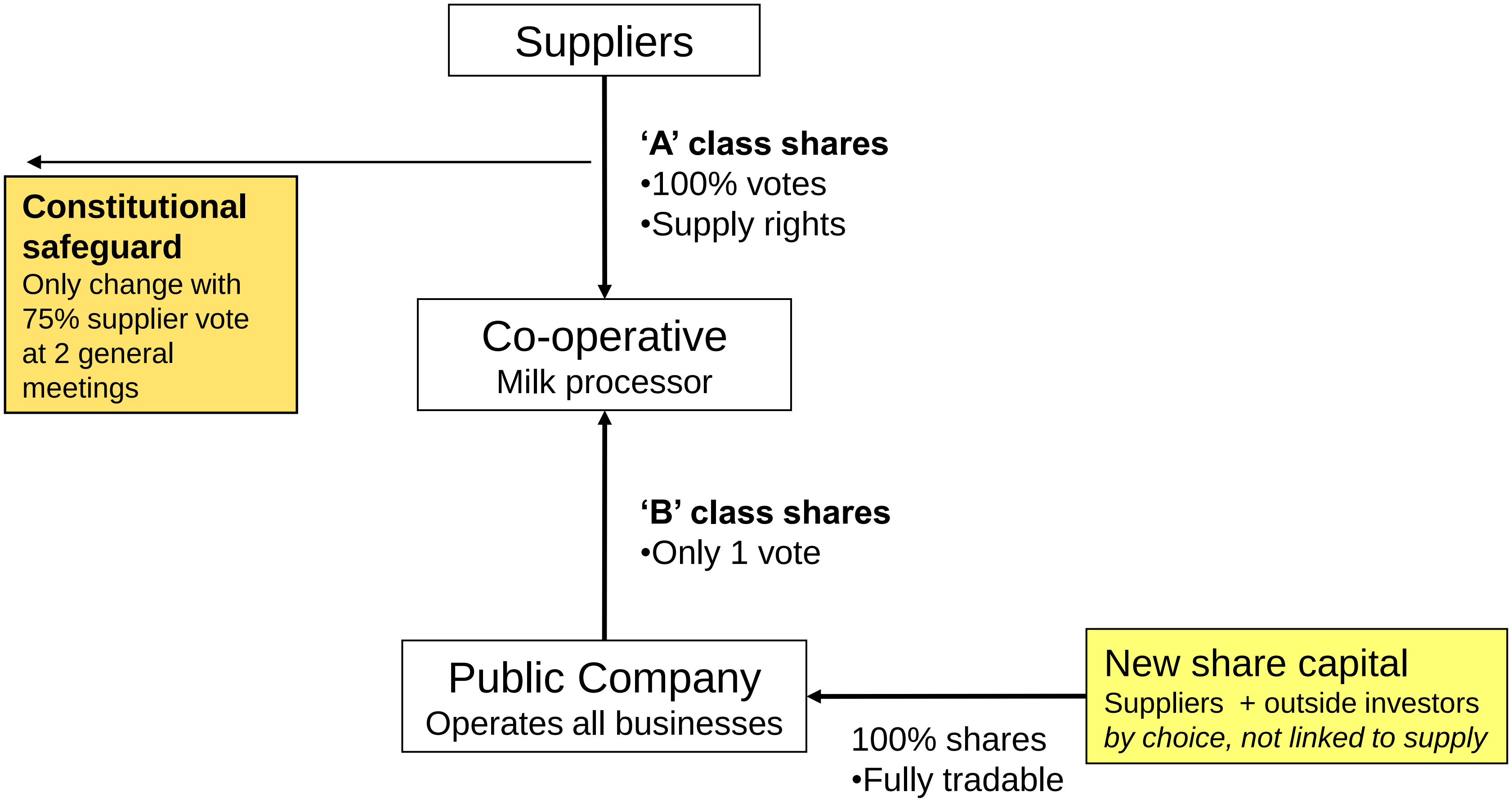
An 'A' and 'B' share structure is used by Air NZ, Livestock Improvement Corporation and Friesland Coberco (Netherlands)

Public company controlled by co-op



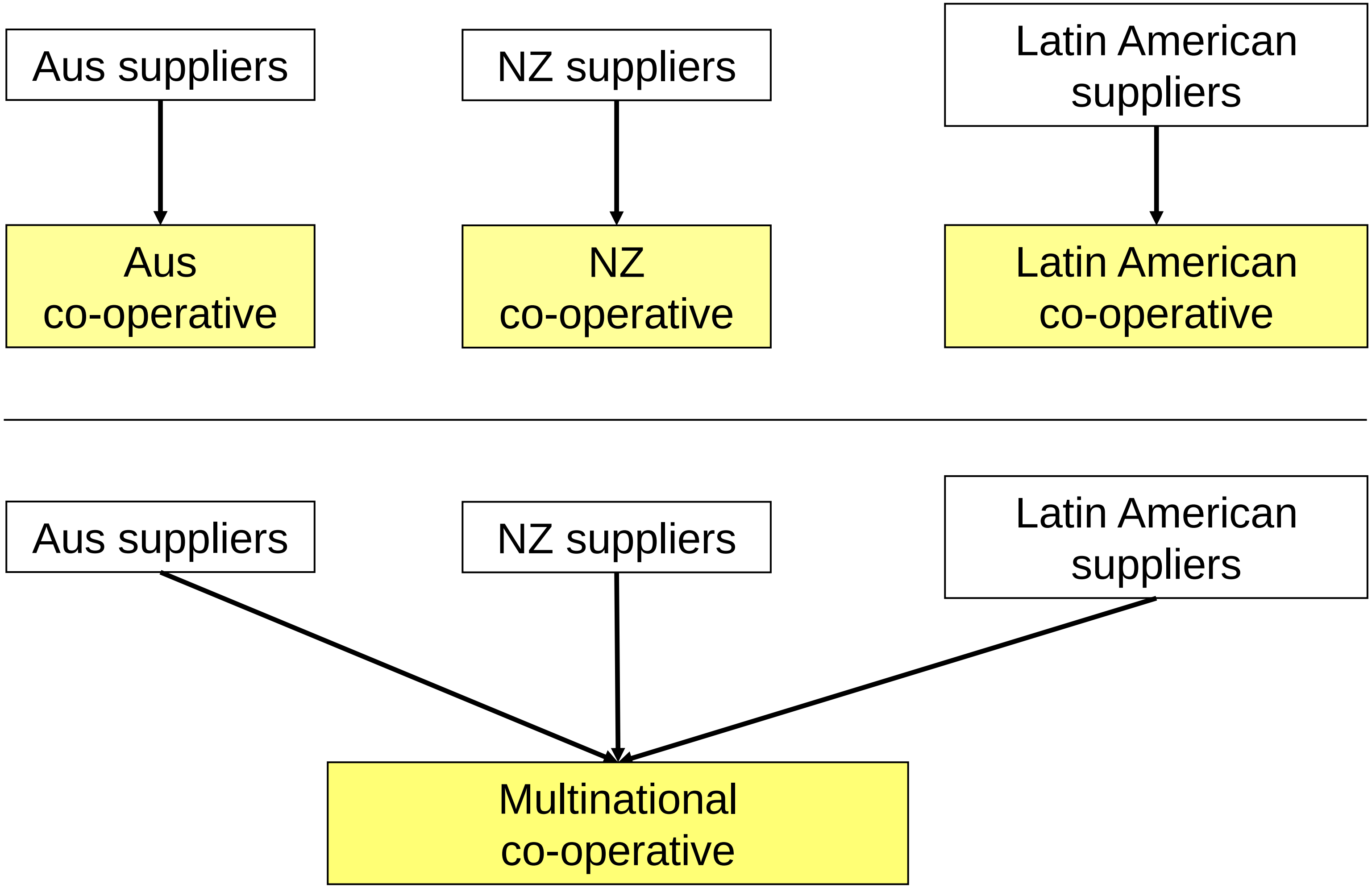
This structure was used by Kerry PLC and Glanbia PLC (Ireland)

Public company with shares in co-op



This structure was used by Golden Vale PLC (Ireland)

Multi-national co-operative



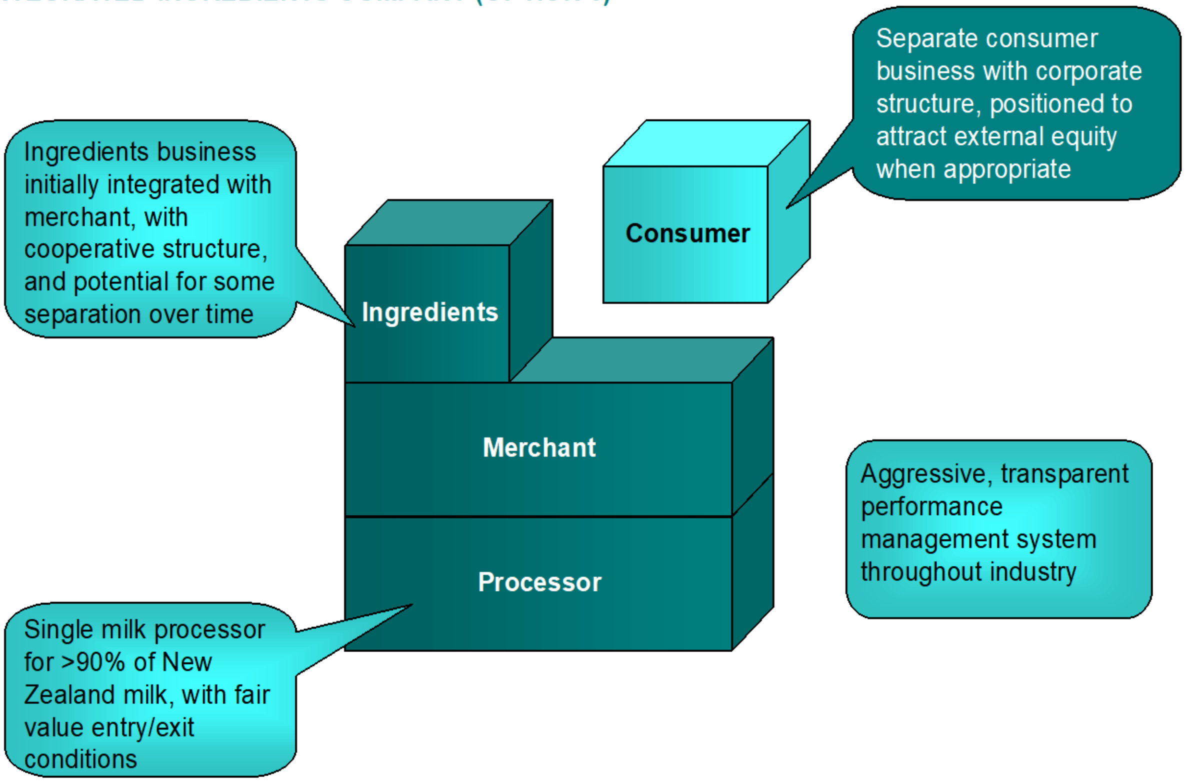
This structure is used by Arla (Denmark) and MD (Sweden)

1999 Plan

The 1999 mega-merger plan included separating the 'consumer' business into a separate company with outside shareholders. The ingredient business could also have been separated over time

Exhibit 1

INTEGRATED INGREDIENTS COMPANY (OPTION 6)



Source: McKinsey

Business features

- Many industry leaders have recognised for some time now that a traditional supplier cooperative structure is not well suited to growing non-commodity businesses, which tend to involve:
  - Higher margins
  - Higher risks
  - Differentiated products, with more reliance on non-milk components
  - More share capital, and
  - A business structure driven by meeting consumers' needs first and foremost

Cooperative problems

- A co-operative is a perfectly valid business structure. Like the alternatives, it has pros and cons. For a large scale consumer-end dairy foods business, the cons tend to outweigh the pros

- The key cons – which are widely recognised, even among cooperative advocates – include relatively:

  - Limited access to share capital
  - Weak performance monitoring
  - Less efficient decision-making processes
  - Diverging expectations among suppliers
  - Multiple objectives, leading to lack of strategic clarity
  - Inefficient investments by the cooperative and suppliers, and
  - Lack of capital diversification by supplier/shareholders

Structural requirements

If Fonterra is to try to compete against (or emulate) Danone, Kerry, Kraft and Nestle in higher-value markets, its non-commodity business needs:

- Shares de-link supply – to access more capital
- Shares to be tradable – to achieve proper monitoring and avoid unnecessary redemption risk
- A normal company structure – to establish clear governance and accountabilities
- A separate strategy – focused on relevant market opportunities and risks, and
- Fresh director and management skills

'Outside' shareholders

- The idea of outside shareholders hits at the heart of a long and deeply held fear within the industry – that non-supplier shareholders will exploit suppliers and not pay a fair milk price

- Suppliers have seen closed cooperatives as their protective shield against exploitation. For over a 100 years, the industry has worked to drive out competition and non-supplier investors

- The irony is that this strategy has been self-defeating. It has made suppliers *more* vulnerable and led to the present conundrum –
  - how to re-introduce non-supplier investors
  - how to introduce non-investor suppliers
  - in both cases, without a competitive market for raw milk market or Fonterra shares

Public company milk price

A review compared raw milk prices between 1994 – 97 paid by Kerry and Glanbia – two public companies – against Dairgold, a cooperative:

- All paid virtually the *same* milk price
- However, Kerry and Glanbia each achieved higher returns on sales and assets
- No evidence that public companies paid less than cooperatives

Non-member supply contracts

- Allowing farmers to supply without investing in Fonterra is another option for:
  - Reducing Fonterra's redemption risk
  - Lowering barriers to supply, thereby securing required milk volumes, and
  - Enabling farmers to diversify their capital investment more efficiently
- Many cooperatives allow non-shareholders to supply, including:
  - Arla MD, its UK business, and
  - Campina Melkunie (Netherlands)

Separate shares and contracts

- A share in a traditional dairy co-op normally bundles three things:
  - A normal share, with rights to vote and receive dividends and obligations to pay capital, and
  - A 'right' to supply any volume of raw milk
  - An 'obligation' on the co-op to collect and process all raw milk and distribute 'surpluses' equally across all milk
- Dairy farmers put a very high value on the right to supply and the obligation to process
- There may be advantages in separating the milk supply contract from the shares

Separate shares and contracts *(cont'd)*

- A menu of contract options could be offered by Fonterra with different features:
  - Fixed or variable volumes
  - Fixed or variable prices
  - Prices in advance, monthly or seasonal
  - With or without hedge cover
  - For different durations
- Suppliers and Fonterra could then select the option that best reflected their respective abilities to manage different risk

Section 8:
Changes in Co-operatives

Political history

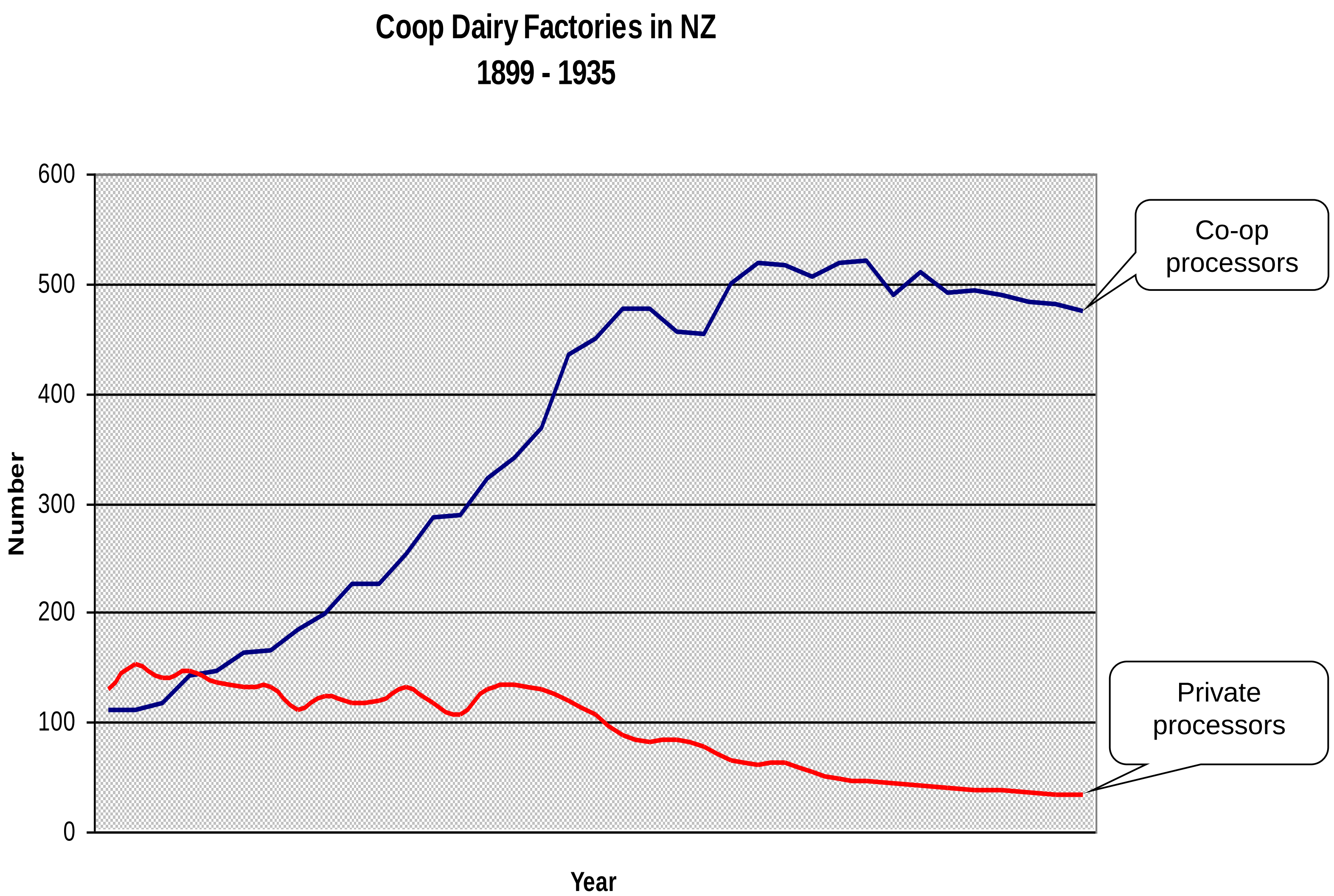
- The NZ dairy industry is deeply rooted in NZ's social and political history
- In the 1890s, dairying was vigorously promoted by the NZ Government to attract unskilled and relatively poor workers to immigrate from the UK to settle in NZ

"The untold enduring wealth of NZ lies upon the surface…and the cow is the first factor in the way of securing it…We have only to make the prime article in butter and cheese, then no power on earth can stay the flow of *white gold* in this direction."
William Bowron, **1894** – 'Chief Dairy Expert' for the Government

Government role

- The Government provided a range of supports to get the industry started, including:
  - Financial assistance
  - Regulations around processing and standards
  - Legislation to help set up cooperatives, and
  - On-farm advice on how to operate a dairy
- From 1870 to 1910, the Government's farm advisers (then called 'Government Dairy Experts' strongly promoted the formation of cooperatives

Growth in dairy co-ops



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)

Chew Chong of Taranaki – an early private processor – paid cash for milk (rather than goods like many processors), but was effectively driven from the industry by suspicious farmers

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)

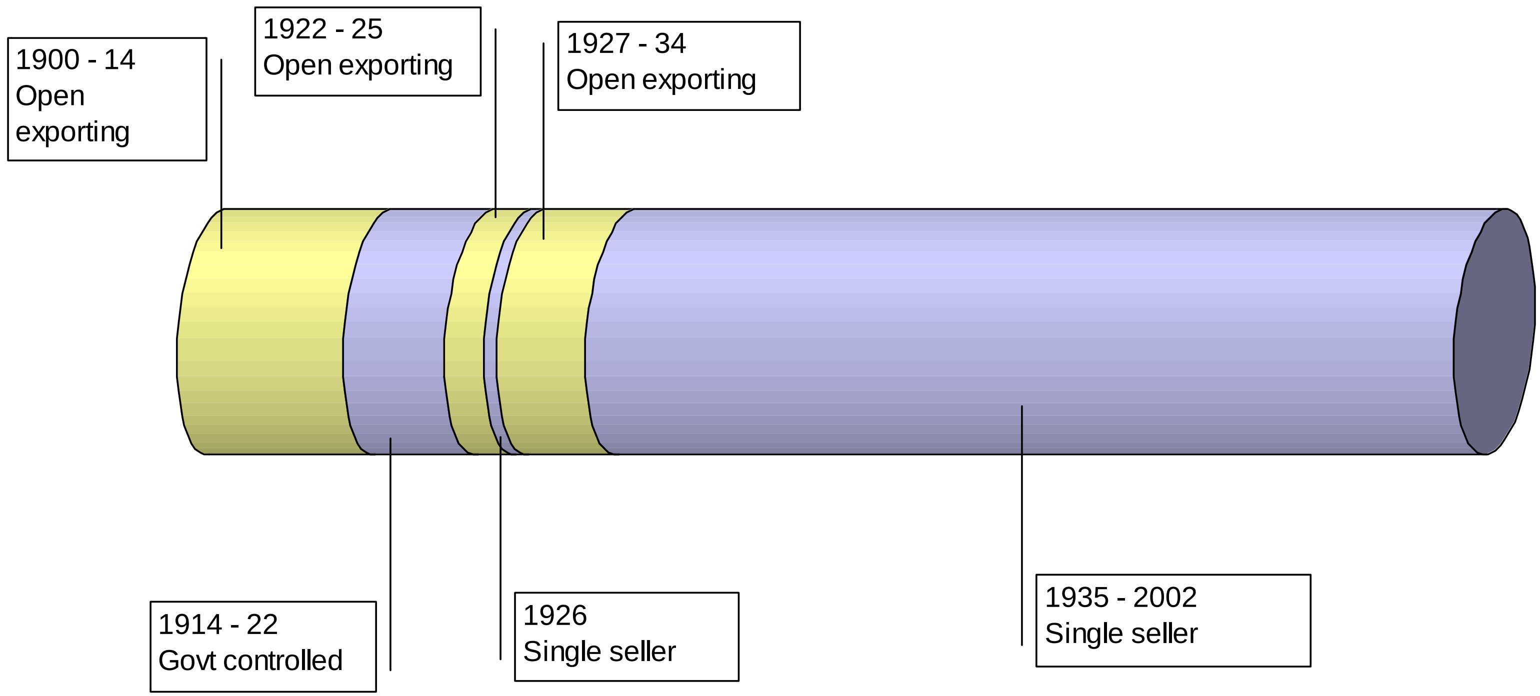
- “After a slow start, the concept of the cooperative dairy company spread **like a faith** – an extension of the small-holder’s desire for as tight a mastery as possible over his destiny” (Gordon McLaughlan)

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

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



Forces of change

- Around the world, traditional supplier cooperatives are now finding it hard to adapt to major market changes, in particular:
  - Consolidation by competitors
  - The power of retailers and food service industries
  - Govts removing special supports for cooperatives
  - New technologies
  - Consumer demand shifting toward more highly processed products – therefore an increasing proportion of the consumer's dollar that accrues to activities beyond the farm gate, and
  - Competing for higher margin products involves high costs and high risks

Hard to adapt

- Traditional supplier cooperatives are not well suited to this new environment
- This is widely recognised among many directors, academics and commentators within the co-operative movement
- The performance is impaired by well known limitations of traditional cooperatives, including:
  - Limited access to capital
  - Weaker performance monitoring
  - Less efficient decision-making processes
  - Diverging expectations among suppliers
  - Multiple objectives, leading to lack of strategic clarity
  - Inefficient investments by the cooperative and suppliers, and
  - Lack of capital diversification by supplier/shareholders

No ideology

- I have *no* ideological views about cooperatives. In legal terms, a cooperative is simply an incorporation by which many people act as one

- It is a perfectly valid vehicle for doing business with various pros and cons which should be evaluated objectively by shareholders in selecting the legal structure most consistent their business objectives

- In nutshell, structure should follows strategy. Some strategies can be best achieved by cooperatives

- To quote Bengt Holmstrom, Prof of Economics at Massachusetts Institute of Technology: "[Cooperative forms are] not anomalies, but competitive institutions that form an integral part of a healthy market economy"

Cross-roads

"[However] 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

Conflict with principles

- The key requirements for competing in more complex , consumer-orientated market tend to cut across some of co-operative ‘articles of faith’, in particular the need to:
  - Send suppliers real market signals, not averaged prices
  - Provide higher rewards to suppliers that better respond to market signals. This means differential pricing among suppliers and not averaging costs (like transport), and
  - Reward capital separately from suppliers’ raw material, as capital is likely to have a higher value in the business
- Unless these changes can be made, it is *unlikely* that a traditional supplier cooperative will succeed in capturing higher value opportunities at the consumer end of the market

New co-op forms

- A variety of hybrid co-op forms are emerging in response to these pressures
- Tatua is an example of a type of ‘new generation co-op’ (NGC) – this model tends to be used by smaller, entrepreneurial co-ops seeking to control the volume of suppliers’ goods, and to orientate their business to satisfy consumer demand in niche markets
- Other hybrid models are described in the section above on capital structure

New approaches

Traditional Co-op	Variations in Hybrid Co-ops
• Open membership	• Closed
• Right to supply all production	• Tradable fixed supply contracts
• $1 in, $1 out	• ‘Market’ value on entry + exit
• Shares linked to supply	• Trading ‘B’ class shares
• No return on shares	• Pay dividends
• Equal pricing across all suppliers of all volumes + locations	• Equal pricing across all suppliers of *similar* volumes + locations
• Cost averaging	• More ‘user pays’
• Product ‘out’ like product ‘in’	• Product ‘out’ differs significantly from product ‘in’

Costs of total control

Bengt Holmstrom, Prof of Economics at Massachusetts Institute of Technology, pointed out in a 1999 paper on the future of cooperatives:

- The role of ownership is to gain the ability to influence decision-making via a direct governance
- However control involves trade-offs between –
  - Owners trying to maximise *their* share of the pie versus
  - Increasing the *overall* size of the pie
- 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
- Capital markets are much better at deciding the pros and cons of opportunities for a firm to diversify. Total closed control (with no trading of shares) denies shareholders this key benefit

Value of traded shares

Bengt Holmstrom *(continued)* –

- A market for shares may be imperfect but it easily beats alternative ways of assessing future potential – “Any other man-made measure falls far short of this mark” [eg Fonterra’s fair value share mechanism]

- Traditional supplier co-ops are at a disadvantage in the innovation race because of:
  – Divisions among members with different objectives, and
  – The absence of essential tools for measuring the potential value of new opportunities requiring capital

- When resources and rights need to be moved long distances (eg diversifying into a new field), external capital markets (traded shares) have a comparative advantage relative to internal capital markets (where directors and managers decide)

Farmers' challenge

- Too many people in the industry automatically revert to the 100 year old cliches 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 cliches to one side. The idea that markets are in conflict with cooperation is a serious misconception

Section 9:

Kerry Group (Ireland)

Early 1970s

1972

- Kerry was a private processor with three shareholders:
  - 42.5% Dairy Disposal Company (Govt owned)
  - 42.5% a confederation of eight small farmer co-ops in County Kerry
  - 15% Erie Casein Company from USA (which guaranteed a market for output of edible casein output)
- Jointly committed €200,000 to finance a €1m processing facility

1973

- Ireland joined EEC
- Kerry restructured into a cooperative
- Suppliers' investment valued at €1.25m

1974 - 79

- Organic expansion, simply taking increased milk supply
- Grew to process about 120 million gallons

Late 1970s

Late 1970s

- Lost 20% of production in brucellosis eradication programme
- EU introduced quota on lower production level
- Profits fell
- Merger not an option, so had to expand sales outside milk

Early 1980s

- Purchased key consumer food brands in UK and Ireland, in ‘chilled’ dairy and meat sections of supermarkets
- Then wanted to buy US specialised food ingredient business, Beatrice Specialty Products
- Did not have sufficient shareholder funds

Since 1986

1986

- Kerry floated as a public company
- Co-operative held at least 51% of shares
- Individual suppliers also purchased shares directly

Since 1986

- Achieved 15% pa growth in earnings per share
- Substantially grown ingredients business
- Aggressively purchased companies around the world
- In 2000, acquired Golden Vale plc, which had also diversified out of milk (over 60% of sales in consumer foods)
- Dairy now accounts for 10% of revenues
- 80% of raw materials are now purchased on world markets
- Value is returned in the form of dividends and increases in share value, not milk price

Without question, the quality of Kerry's leadership team has been a key factor in its success

2004 Structure

- Kerry Group
  - Flavours
  - Ingredients
  - Agribusiness
  - Foods

Flavours

Seasonings and flavourings to food or beverages

Mastertaste
Burn Philip

Ingredients

'Ready-to-use' foods
Fresh + natural products

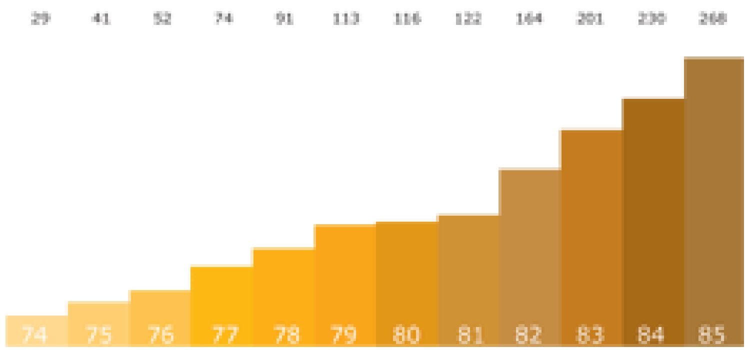
Foods

Product range includes sausage, sliced bacon, sliced meats, pastry products, ready meals, ready-to-cook products, savoury snacks, specialty poultry, cheese, cheese snacks, dairy spreads, low-fat spreads, desserts, UHT products, home-baking products, salads, sandwiches, mineral water, flavoured waters, fruit juices, cream liqueurs and ready-to-drink cocktails

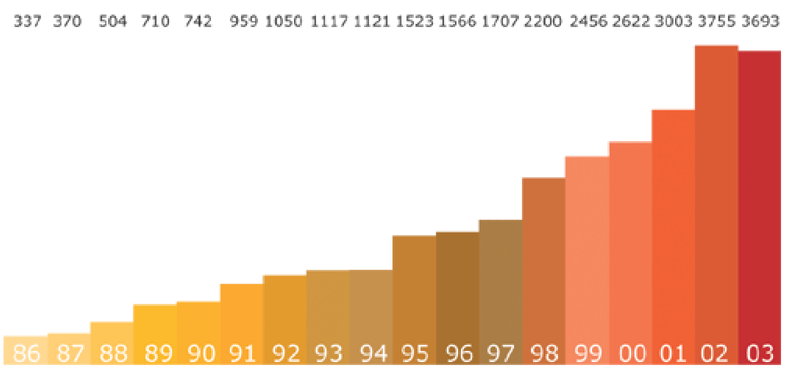
Dairy now accounts for 10% of Kerry's revenues

Growth in revenues

Turnover 1974 - 1985
(€million)



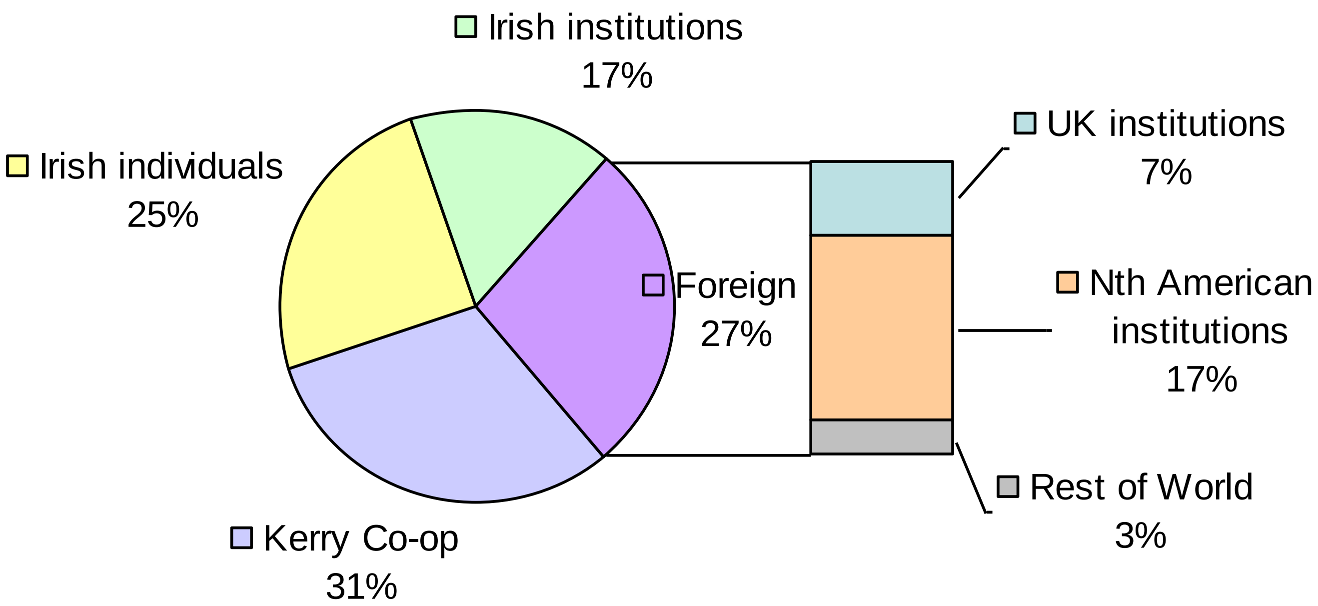
Turnover 1986 - 2003
(€million)



Shareholders

- In recent years, co-operative members decided to reduce the co-op's holding to 31%. Only possible with 75% vote of co-operative members

- Kerry's shareholding new looks like this –



Value of co-op's 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**

The value of members' investment in the co-op increased significantly even though the co-op's control of Kerry plc has decreased

100% control does not necessarily increase in value

Copy Kerry?

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

"..if the greater part of one's raw materials come from supplier members…it is much easier to reward members through raw material pricing…..going the [public company] route will not work…"

"…one cannot go [the public company route] where the shareholders are the predominant suppliers and where there is an expectation that returns will accrue to shareholders in raw material pricing as distinct from in share value which is the real measure of [public company] performance…"

"The [public company] came about in Kerry after we had diversified away from milk and at a time when we were well on the way toward pursing our global expansion plans"

"For those contemplating this route….have little or none of your products in the commodity category as stability of profits is the overriding priority…"

"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…"

Section 10:
Tatua

Profile

- Members within 16km of plant. Close-knit community
- Unlike Fonterra, no issues of transport cross-subsidisation or significant qualitative differences
- 138 members
- Stable supplier base for past 12 years
- About 145 staff
- Processes 1% of NZ's milk supply (compared to Fonterra's 97%)
- About 90% of production is exported
- About 70% of revenue comes from higher margin products

2002/03 Results

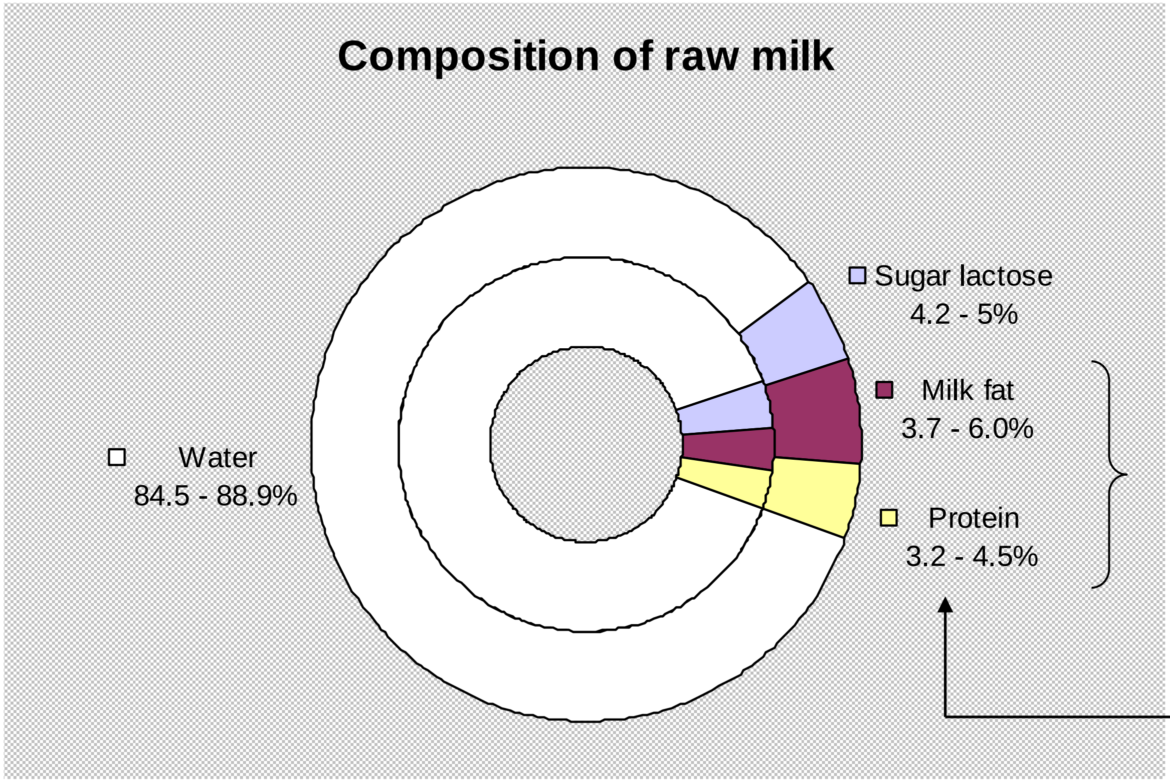
- Total revenue: $122.4 million
- Milk processed: 11 million kg of milksolids
  - Up 18.2% on previous season
  - Increase for total NZ industry was 2.2%
- Purchased 14.3 million litres of milk from Fonterra
- Sold commodity products (caseinates, WPC and cream) to Fonterra
- Since 1993, revenue has grown 10% on a compounding basis

Strategy

"To seek a uniquely NZ position in international markets, given our small domestic market and geographic isolation in the world. We should place a greater emphasis on products yielding high margins and less on large scale, low cost commodities"

Dr Alan Frampton, Chairman, Tatua – 2002

Focus



"Milk solids" only includes fat and protein

Source: NZ Geographic, Livestock Improvement Corporation, Tatua

Tatua focuses on milk's constituent parts, developing bioactive compounds for nutritional and pharmaceutical industries – eg *lactoferrin* – a milk protein with iron binding properties, used in geriatric goods and infant formula

30 year path

Tatua's objective is to be a specialist food company. Its strategy was devised in 1970s –

- Limit milk supply - cap on new members. Do not accept new milk unless it adds value to suppliers' incomes
- Invest in R&D
- Differentiate and focus on niche or specialised markets
- Remain independent and do not follow merger trend
- Tatua became known for its technical capability – NZ Dairy Board regularly went to Tatua for trial runs of experimental products
- 1979 – aerosol cream-in-a-can. Also used as a platform for bag-in-a-box technology (cheese sauces and soft-serve ice cream)

Capital structure

- Early 1990s, Tatua developed bioactive compounds like lactoferrin
- In early 1998, Tatua realised the NZ Dairy Board's 'Competitive Pricing Model' (1997) and 'Business Development Project (1998) would "inevitably lead to one very large company, together with one or two small specialist companies" (Frampton, 2002)
- Tatua studied features of 'New Generation Cooperatives' used mainly in crop and livestock cooperatives in the USA – adapted this model to suit Tatua
- In 1999, Tatua changed its capital structure – issued 'Milk Supply Entitlements' (MSEs)

MSEs

A ‘Milk Supply Entitlement’ is a separate share, which has these key features:

- No redemption value
- No voting rights
- Issued at no cost
- Transferable (tradable) among shareholders
- ‘Market’ value of MSEs reflects shareholders’ view on future earnings
- One MSE must be held with each share
- Shares still at nominal value and held in proportion to supply
- Number of MSEs issued corresponds with Tatua’s peak milk capacity. Allowed for 32% increase in production
- Milk in excess of MSEs does not receive full payout

Benefits of MSE

- Low redemption risk – a problem Fonterra faces (risk of ‘run’ on Tatua’s capital from farmers ‘cashing up’)
- ‘Market’ signals of Tatua’s performance, reflected in price of traded MSEs
- Enables farmers to more readily adjust production levels and capital investment portfolio
- New milk pays full costs (avoids dilution of existing suppliers’ value in Tatua)
- Matches production to processing capacity (enables Tatua to better manage inflows and capital investment)
- Avoids problems of Fonterra’s ‘peak notes’
- Avoids problems of Fonterra’s complex redemption protections
- Avoids problems of Fonterra’s artificial/administered share valuation process

Current structure

Tatua

75% of revenues

25% of revenues

Nutritional

Formed in 1979. Nutritional ingredients and formulations, including precise protein products as caseinates, whey protein concentrates (WPC), hydrolysates and biologically-active lactoferrin

Foods

Range of sauces, ice cream mixes + other consumer and food service products – based around UHT milk + cream

Relative efficiency

2001	Tatua	Fonterra
Milksolids processed per employee	64,000 kg	55,000 kg
Revenue per employee	$760,000	$700,000
Revenue per $1 of assets	$1.61	$1.17

Tatua says its economic value added (gain above cost of capital) for 2002/03 was 50.5% assuming a WAAC of 10%. Fonterra does not use the EVA methodology but its EVA would appear to be quite low. Its WAAC is around 8%

Key features

- Tatua's assets are relatively flexible – can be adapted to a range of different products
- Aims to utilise plant 12 months, 365 days a year (eg buys cheese from Fonterra and turns it into cheese sauces in off-peak season)
- Used Fonterra's extensive international network for placing its specialty products. (Ties now cut?)
- Strong culture of science and seeking new value – described by Tatua as an "enabling" environment
- Customer-driven ethos
- Seeks to avoid preoccupation of processing ever growing peak supply, which dominates Fonterra's operation

Leadership team

- Just seven CEOs since 1914
- Neil Dewdney CEO for about 20 years (early 1970s to 1995)
- Dr Mike Matthews since 1995
- Dr Alan Frampton – chairman for 12 years
- Contrast to ‘hot seats’ approach at NZ Dairy Group, NZ Dairy Board and Fonterra over recent years

Future

- Focusing on new milk components – eg naturally occurring milk enzyme, lactoperoxidase
- May diversify into soy or wheat protein or other compatible food protein
- In February 2004, set up a new subsidiary – Tatua Japan – to service its most important market (30% of revenues from Japan)
- In June 2004, cut commercial ties with Fonterra
- Developing a range of overseas markets