Country-Wide

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Article on Fonterra's capital structure

By Tony Baldwin

Sort out peak notes. Lower the cost of supplying more milk. Keep the payout well above $4. Get NZ Milk cranking. Do these things and Fonterra is in good shape. This is how most dairy farmer see it.

Ideas like separating NZ Milk, or contracting for market-driven volumes, are viewed extreme and dangerous – a recipe for outsider to somehow steal suppliers' hard-earned gains. This fear of exploitation runs deep. It is old as the industry. Many farmers believe (to quote the *Dairy Exporter*) that outside investors will "turn our children into peasants".

The truth is that Fonterra simply can't unlock its full potential without parcelling its downstream businesses into a separate corporate structure with tradable shares. A few years down the track, outside capital will be required if Fonterra is serious about growing value and properly spreading risk.

Fonterra's board is not fronting up. The directors are not being intellectually honest. They know Fonterra needs fundamental change to deliver full benefits. But they don't know how to lead these changes with dairy farmers. After such a long history of misinformation and mythology, it would feel like a cultural revolution for many suppliers.

Fearing the backlash, directors have once again chosen the short term path of least resistance, excluding key issues and options from the current capital structure review.

All over the world, dairy cooperatives concentrate on commodity and fresh milk products – the low margin end. The high margin end is dominated by corporates like Kraft, Nestle, Danone and Unilever. There are very few examples of a dairy cooperative succeeding in high margin markets.

Traditional supplier co-ops work best when capital demands are relatively low, the product supplied is very similar to the product manufactured, and suppliers share the same goals and appetite for risk. Co-ops in many countries also rely on special government treatment, including exemptions for anti-monopoly laws, tax concessions and other special deals. Change any of these factors and traditional supplier co-ops start to struggle. Their form no longer fits their function.

The tensions become particularly acute when they try to move into high margin consumer markets. Their ability to innovate and compete is handicapped by lack of funds, inefficient price signals, divergent shareholder goals, weak performance monitoring, and their greater focus on producers than consumers.

This is not an ideological beat-up on co-ops. These problems feature in commentaries by leading cooperative academics and directors around the world.

The bottom-line is that downstream food businesses are significantly different from milk collection, milk processing and commodity trading. They require different strategies, different expertise, different resources and different risk-management. Capital is the primary input, not milk. Consumers are paramount, not suppliers. Shareholder returns are to be maximised, not the price of raw milk.

Jens Bigum, head of Arla Foods, the world's No 2 dairy co-op (ranked above Fonterra in 2003), commented earlier this year that "the dairy sector is seeing an extremely tough elimination race, and we find ourselves competing against global giants like Nestle and Danone, which have very strong capital bases. In order to survive and to pay one of Europe's highest milk prices, we need a substantial amount equity capital".

Fonterra is at a cross-roads. It has to sort out what its goals are and how it is going to achieve them. The current set up is a muddle of euphemisms and contradictions, with Fonterra pretending it can be both an open customer-driven corporate and a closed supplier-driven cooperative, all within a single structure. It is simply not credible.

Despite the endless rhetoric about growing 'value-added' and becoming smarter at commodities, Fonterra's real number one objective is to ensure it continues to be owned and controlled exclusively by NZ dairy farmers. Equal wealth distribution among suppliers also ranks high in its Cooperative Philosophy Statement. The socialist roots of the co-op movement still float close to the surface.

Five years ago, dairy leaders were saying milk growth was too high and co-op share prices were too low. Now they are saying the opposite. Fonterra wants more milk, even if it comes from non-shareholders. It will also need capital from outside investors if it wants to grow. In both cases, a real milk price will have been separated from returns on capital.

The problem is we do not have a competitive raw milk price in NZ. Since the 1890s, competition has been viewed as "pernicious" (in the words of an early industry chief, Mr D Cuddy) and successive leaders have worked relentlessly to eliminate it.

Rather than making suppliers more secure, killing competition has weakened pressures to perform and made it much harder for the industry to adapt to new challenges. It has put Fonterra on a cliff-edge, where its current structure is not well suited to the markets in which it wants to grow, but change is hard to embrace.

The question is not whether fundamental change is needed – it clearly is and the leadership knows it (see box below). The key issue is who will lead it and how. A few have tried, but been pushed aside. Do Fonterra's current directors have the courage?

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Key changes required at Fonterra

- Contract for milk volumes and durations that match Fonterra's business plan. The current system of accepting however much milk produced is inefficient
- Establish competitive market prices for raw milk for different periods
- Do not require suppliers to buy Fonterra shares at market value in order to supply. [Among other things, this is because a share buys the net present value of expected future profits *after* paying for milk. A share does not buy future milk price payments]
- Separate the milk price from dividends
- Parcel downstream activities into a separate company with tradable shares de-linked from milk supply. It could be 51% controlled by Fonterra
- Allow co-op shares to be traded among suppliers within a band (80-120%) of milk volume supplied
- Sell down about 12% of Fonterra's milk collection business to get free of Government regulations requiring it to accept all milk produced and supply competitors

Diagram of proposed structure for Fonterra's downstream business

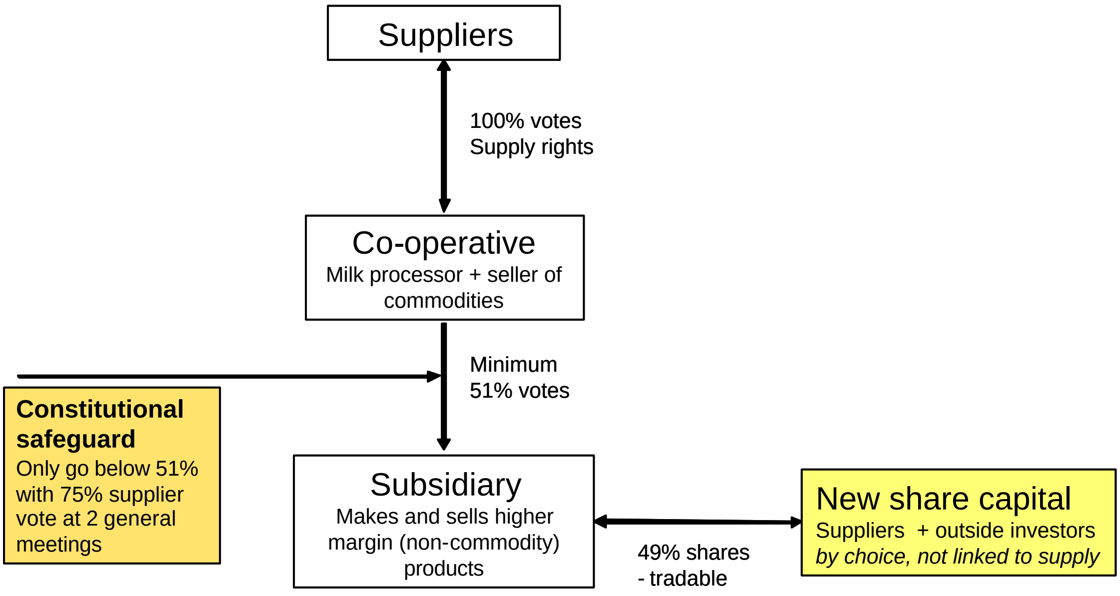
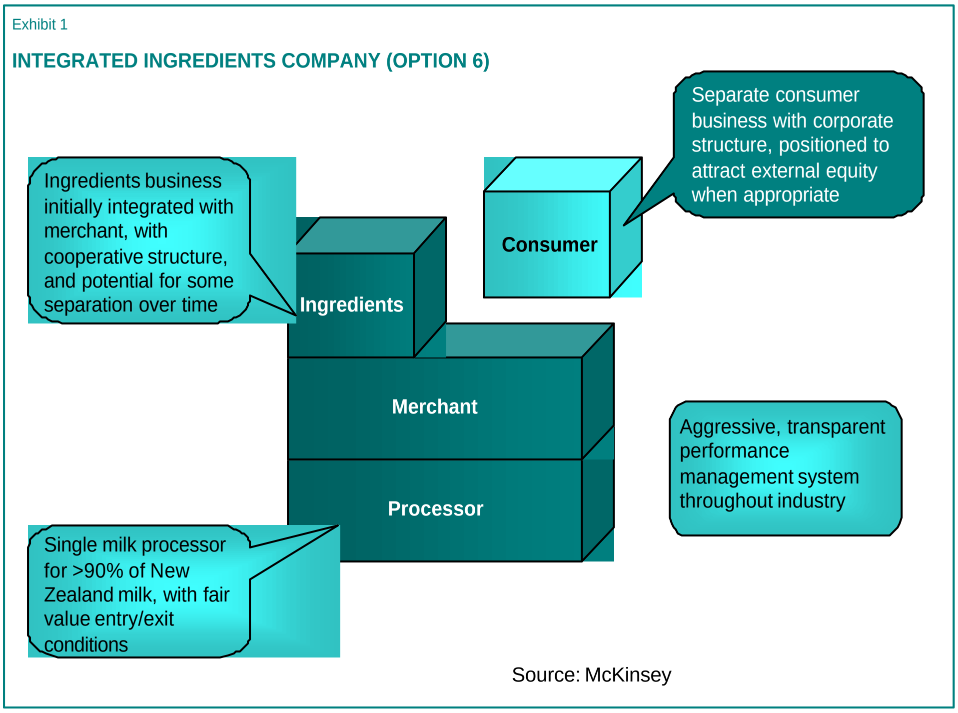


Diagram of 1999 industry plan
Essentially the same for 2001 merger that gave rise to Fonterra – shows plan to separate consumer business and possibly ingredients business



2003 World Rankings

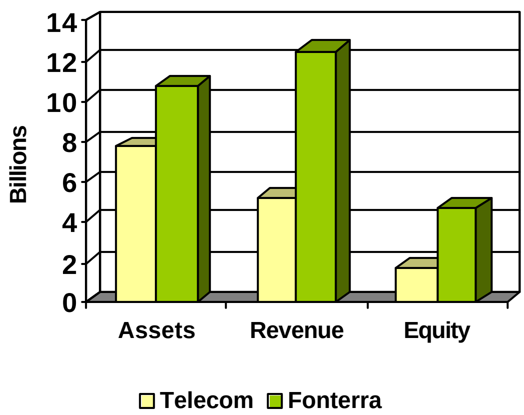
2003	Company		Country	Dairy sales US$b	Total sales US$b
1	Nestle		Swiss	15.3	54.25
2	Dean Foods		USA	7.1	8.91
3	Dairy Farmers of America	*Co-op*	USA	6.4	Nil
4	Arla Foods	*Co-op*	Denmark/ Sweden	6.1	Nil
5	Danone		France	6.0	12.7
6	Fonterra	*Co-op*	NZ	5.8	Nil
7	Parmalat		Italy	5.8	7.95
8	Kraft Foods		USA	5.3	29.7
9	Lactalis		France	5.2	-
10	Unliver		NL/UK	4.9	25.6

Size in the NZ context

Fonterra buys about 97% of all milk produced in NZ. It was formed in 2001 by special legislation

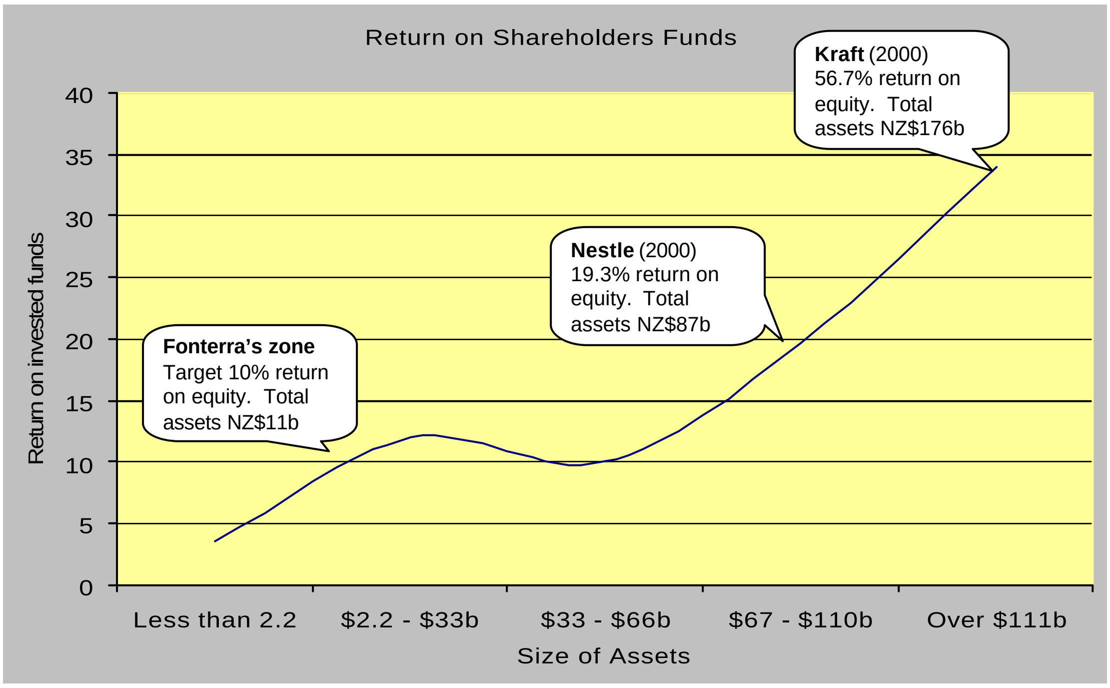
	Telecom	Fonterra
Total	$7.7b	$10.75b
Revenue	$5.2b	$12.5b
Equity	$1.7b	$4.7b

2003 data



Comparative rate of return –

Fonterra compared to consumer-focused competitors, Nestle and Kraft



Source: Promar International

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