Brian Gaynor:

Fonterra's plan critical for farmers' future

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By Brian Gaynor

The proposed recapitalisation of Fonterra will be one of the biggest business stories over the next few months. This objective will be easier to achieve following the approval of the Silver Fern Farms recapitalisation in Balclutha on Thursday.

Why are Fonterra's directors so determined to implement a new capital structure for the group?

This debate is almost exclusively based on Fonterra's balance sheet, the driving force behind the issue.

The accompanying table shows the liabilities side of Fonterra's balance sheet alongside that of Silver Fern Farms, the Dunedin-based meat processing co-operative, and Kerry Group, the former co-operative that underwent a major capital restructuring in 1986.

Kerry's euro figures have been converted to NZ dollars at the December 31, 2008 euro/NZ dollar exchange rate.

The problem with Fonterra is that its shares are not permanent. They are linked to milk supply and if milk supply falls, either through drought or some other reason, shares are redeemed.

This occurred in the July 2008 year when the total value of shares on issue fell from $4897 million to $4297 million as $754 million of new shares were issued and $1354 million redeemed.

There was a slight increase in the first half of the current year, from $4297 million to $4392 million, as more shares were issued than redeemed.

It is extremely difficult to operate a commercial business without permanent capital especially when uncontrollable events - droughts for example - can lead to large redemptions.

The other issue is that Fonterra has virtually no retained earnings as most of its profits are distributed to supplier shareholders through the milk price.

As at January 31 the group had retained earnings of only $14 million and the other equity component of its balance sheet had a deficit of $602 million. This mainly comprised a negative cash flow hedge reserve of $825 million.

Thus, at the end of January, Fonterra had total interest bearing debt plus overdraft of $8213 million and total equity of just $3790 million. Although the co-operative had $751 million of cash and cash equivalents the debt to equity ratio is far too high, particularly as the share component is not permanent.

Fonterra's debt levels are a major concern in an environment where banks are cautious and already have full exposure to the New Zealand agriculture sector.

By contrast Kerry Group has $3239 million of borrowings and $2787 million of total equity, all of the latter in the form of retained earnings. Kerry is a listed company and the beauty of this is that earnings can be retained but still benefit shareholders through an appreciating share price.

Kerry, which was a small regional Irish dairy co-operative, now has a sharemarket value of $7.4 billion. It has substantially outperformed most major international sharemarket indices in recent years and is larger than any listed New Zealand company, in market capitalisation terms.

The difference between Fonterra, the co-operative, and Kerry, the former co-operative, is probably best summed up by their annual reports.

Fonterra's report is chock full of photographs of cows, farmers, milking sheds and milking trucks whereas the Kerry report does not contain any photographs of these subjects, all of its emphasis is on the food items it produces for consumers.

In other words co-operatives, with redeemable shares, are producer orientated whereas companies with permanent capital are much more likely to be customer orientated.

Fonterra has to restructure its balance sheet but dairy farmers are concerned that they will lose control and the company will fall into foreign hands.

Thus, it is vitally important that the directors come up with a proposal that will maintain farmer control but encourages outside parties to contribute badly needed permanent capital.

The aborted 2007 Fonterra proposal, the Kerry restructuring and the successful Silver Fern Farms proposal offers some guidance in this area.

2007 FONTERRA PROPOSAL

A new company called Fonterra Limited was to be formed and all the assets and liabilities transferred to it from Fonterra Co-operative.

The new company would be listed on the NZX with farmers owning 65 per cent through Fonterra Co-operative and a further 15 per cent in their own name. The remaining 20 per cent would be held by the public, although no one shareholder could hold more 10 per cent of the listed company, except the co-operative.

The listed company would have permanent capital and would raise new capital through the 35 per cent of new shares issued to farmers and the public.

It would have to be listed on the stock exchange because it is not possible to attract outside shareholders unless there is a tradeable market for their shares.

KERRY GROUP

In February 1986 dairy farmers in the southwest of Ireland approved the transfer of all the assets and liabilities of Kerry Co-operative to a new company called Kerry Group. Kerry was the country's fourth largest dairy co-op with a 16 per cent market share.

The new company listed on the Irish Stock Exchange with the co-operative owning 80 per cent in the form of "B" shares while farmers held 11 per cent in their own name and the public 9 per cent in the form of "A" shares.

The group's original share market value was $146 million and farmers buying "A" shares in their own names were issued these at 35p each compared with 52p paid by the public for their "A" shares.

Kerry Group has been so successful that farmers voted to abolish the two-tier share structure and the co-operative's shareholding has dropped from 80 per cent to 24 per cent as its shareholdings have been distributed to farmers on a prorate basis.

Approximately 35 per cent of the company is owned by overseas institutions, 31 per cent by farmers and Irish retail investors, 24 per cent by the co-op and 10 per cent by Irish institutions.

SILVER FERN FARMS

Silver Fern Farms supplier shareholders voted 76.5 per cent in favour of a proposal that will enable suppliers to convert their redeemable shares into permanent shares.

Shares that convert will be eligible for a 2 for 1 cash issue at $1.00 a share, followed by a 1 for 4 bonus issue.

To ensure farmer control, suppliers will be entitled to no less than 60 per cent of all voting rights on shareholder resolutions and no one shareholder or group of shareholders may hold more than 5 per cent of the total voting securities.

Silver Fern Farms' new shares will be tradeable on the Unlisted facility but if supplier uptake of the 2 for 1 cash issue is low, the company could migrate to the NZX.

The issue facing Fonterra is clear; its redeemable share structure is unsuitable to the modern world. It has to establish a permanent share structure with the ability to raise capital from non-farmer shareholders.

This can be achieved while still maintaining farmer control.

A recapitalisation is particularly important in the current environment because debt was easy to come by over the past decade but undercapitalised companies will find it harder to prosper in the years ahead as debt funding becomes more difficult to obtain.

Fonterra has no alternative; it has to follow the route travelled by Kerry Group and Silver Fern Farms. New Zealand's dairy farmers will face an uncertain future if they reject the eagerly anticipated recapitalisation proposals.

Disclosure of interest; Brian Gaynor is an executive director of Milford Asset Management.