CO-OPERATIVES: STRUCTURAL OPTIONS

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Outline

- These slides outline some of the structural options for introducing more share capital into a co-operative from outside shareholders, including:
  - A subsidiary with outside shareholders – slide **4**
  - A co-operative with outsides shareholders – slide **5**
  - A public company controlled by the cooperative – slide **6**
  - A public company with share in the cooperative – slide **7**
  - Corporatisation of co-operative – slide **8**
  - A multi-national cooperative – slide **9**
- Fonterra’s current structure is at slide **10,** which does not involve any additional equity from outside sources.

Outline *(cont'd)*

The FrieslandCampina structure is in slide **11**.

The Kerry Group example is in slides **12 to 14**

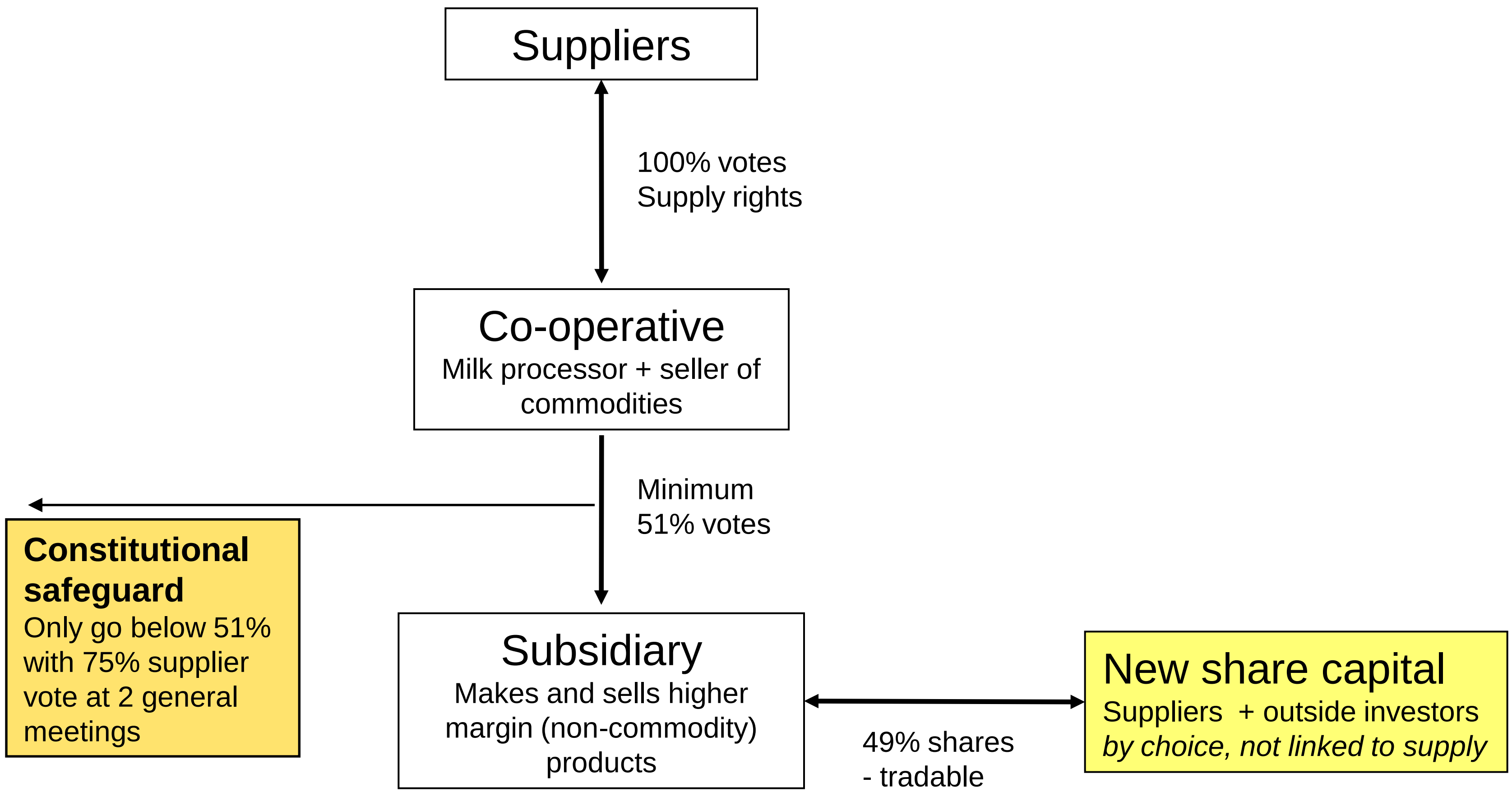
Each option has particular pros and cons, which need to be explored in a separate presentation.

There are also slides on:

- The 1999 and 2001 merger plans – at slides **15 to 18**, and
- The co-operative form and 'vertical market failure' – at slides **19** to the end.

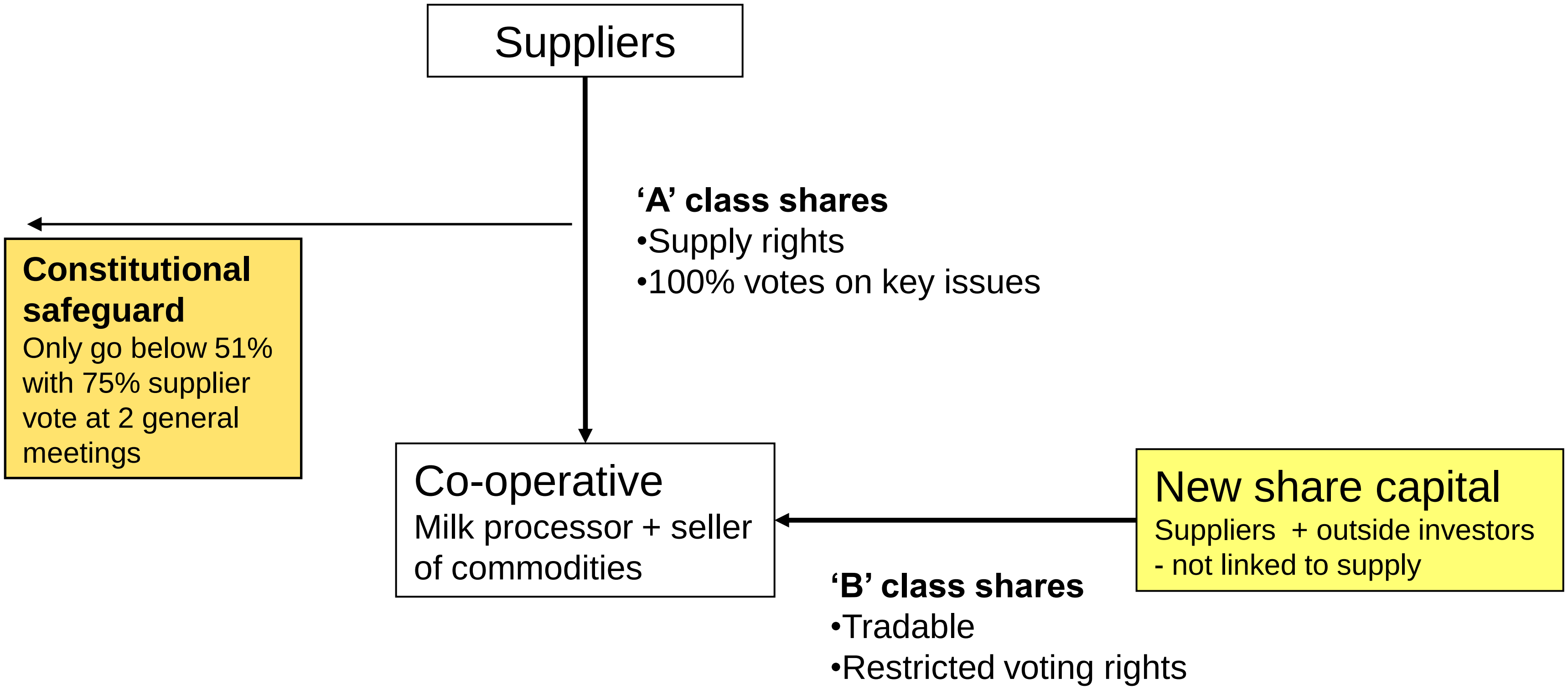
Caveat: These are brief overview slides and do not purport to provide detailed analysis

Subsidiary with outside shareholders



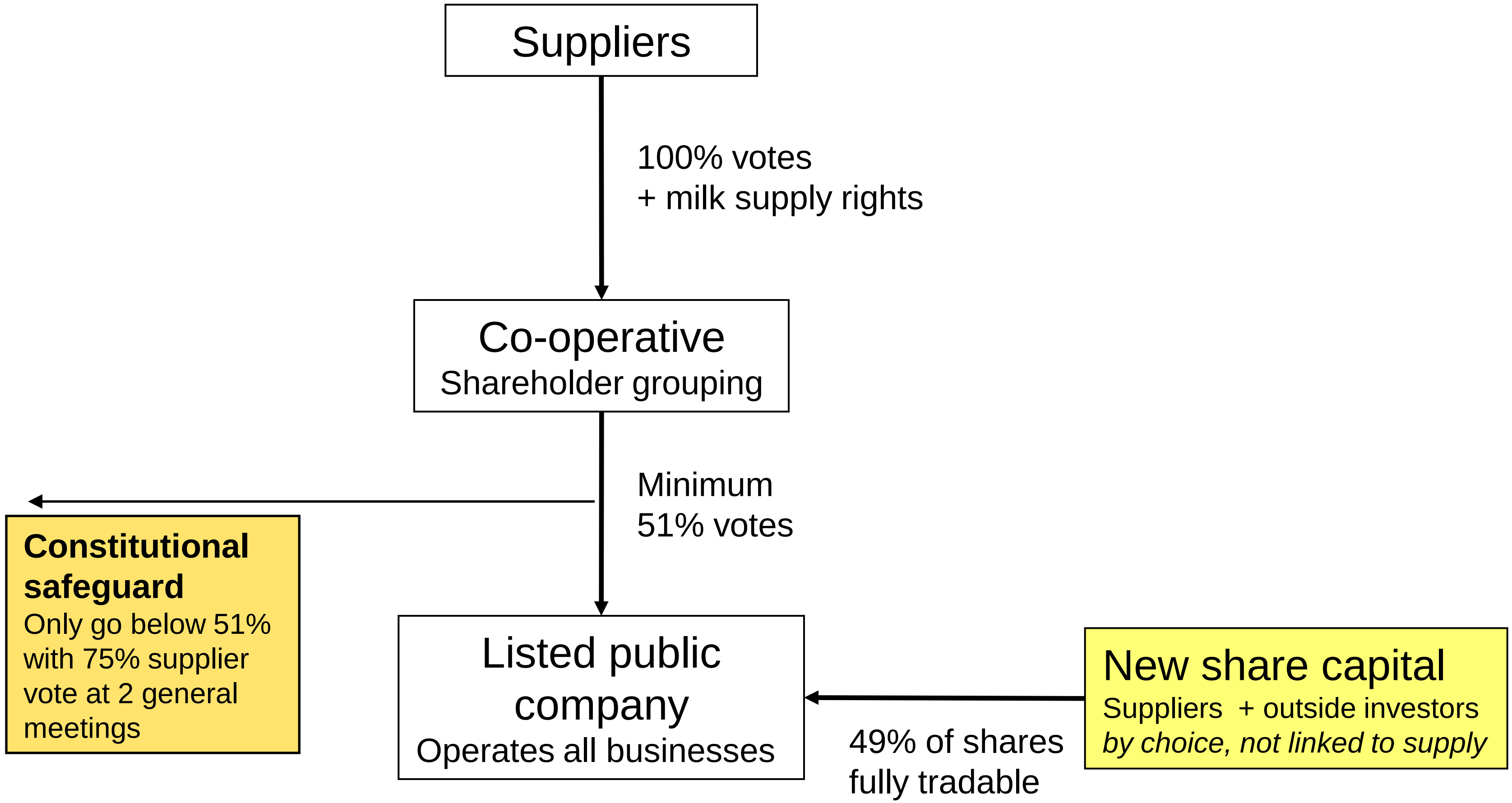
A model like this has been used by three agricultural cooperatives from Finland. Dr Zwanenberg, a prominent co-operative consultant, has advocated this type of model, which may also involve listing shares in the subsidiary [source: Bekkum, O.F. van, and J. Bijman 2006]

Co-op with outside shareholders



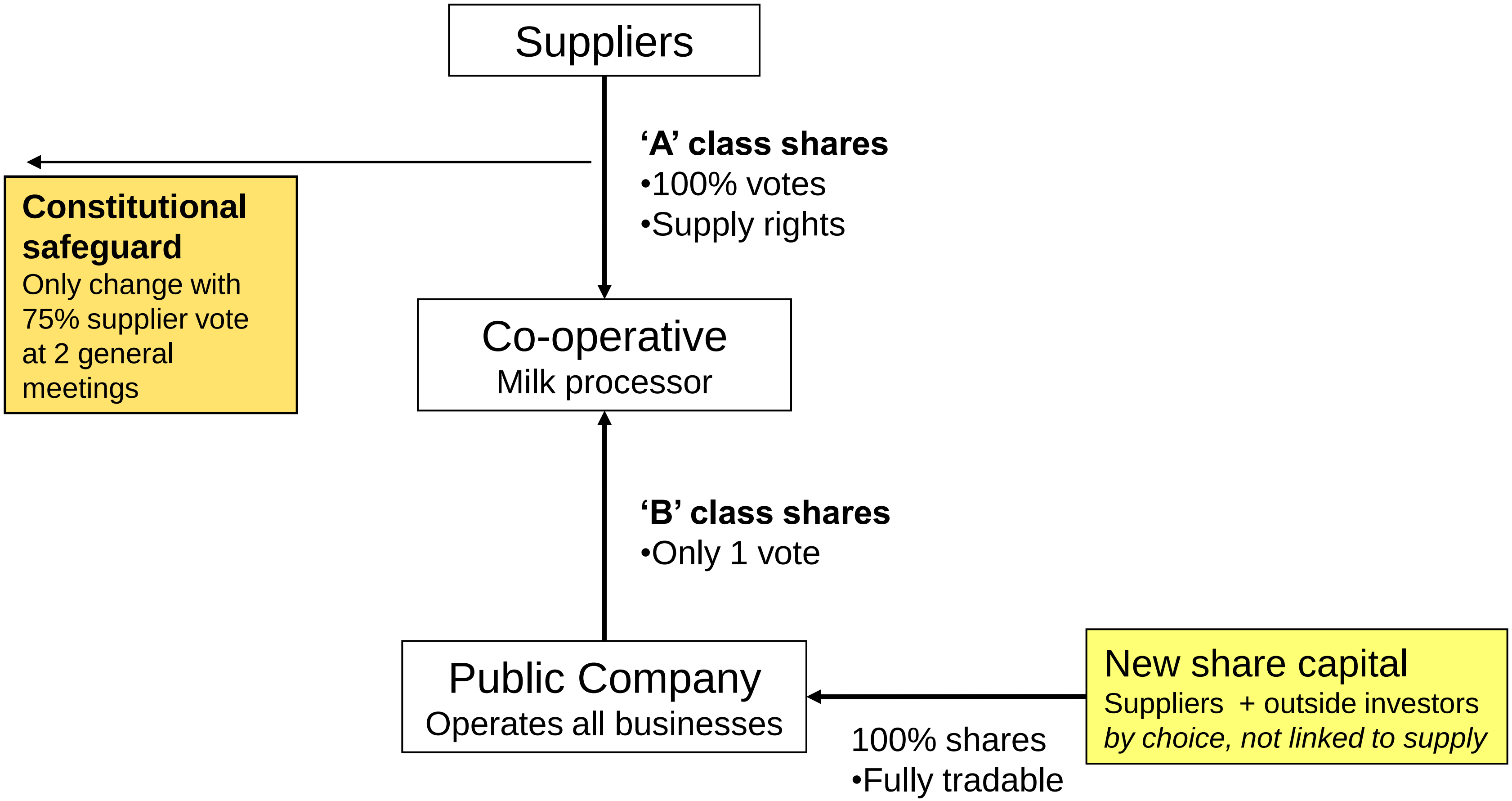
An 'A' and 'B' share structure was used by Air NZ for a period. It is currently used by the Livestock Improvement Corporation. Other co-operative examples of a two-tiered share structure include like Dairy Farmers of America (USA) (2004) and Clover Dairies (South Africa) [source: Bekkum, O.F. van, and J. Bijman 2006]. Before merging with Campina, Friesland Coberco (a Dutch dairy co-operative) also had a two-tier share structure.

Public company controlled by co-op



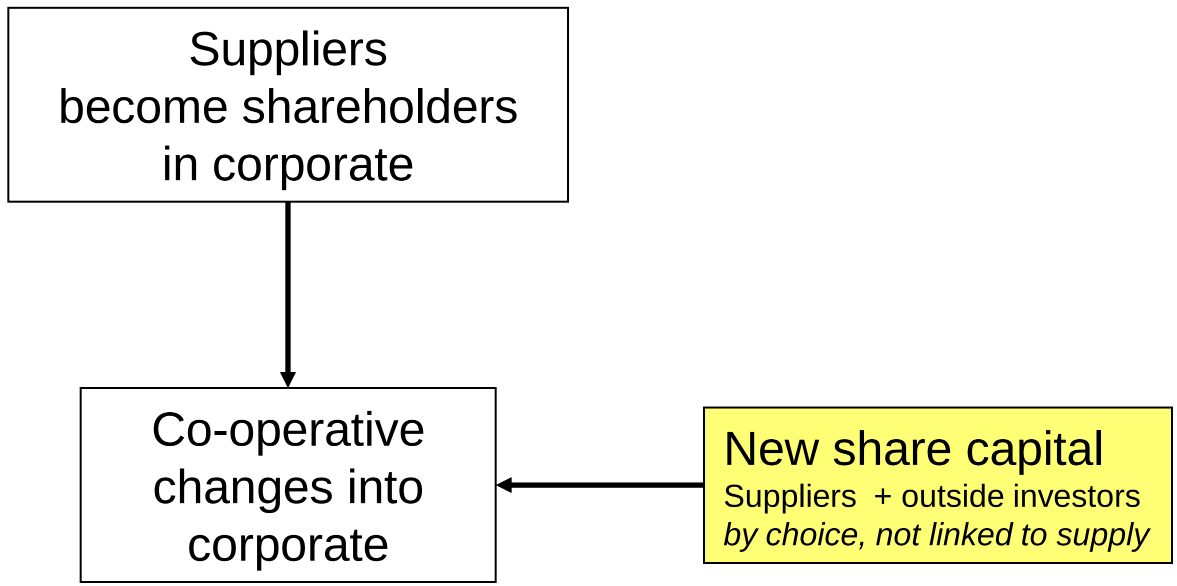
This structure was used by Kerry Group plc and Glanbia plc (Ireland). The Kerry Co-operative's shareholding in Kerry Group has been progressively reduced by special vote of the cooperative's members. Kerry Group's impressive history of growth and diversification is at www.kerrygroup.com/docs/history/Corporate-History-15-2-16.pdf

Public company with shares in co-op



This structure was used by Golden Vale PLC (Ireland) in 1990. It was acquired and delisted by Kerry PLC in 2001

Corporatisation of co-operative



This involves the conversion of the co-operative into an investor-owned company. Non-dairy examples include Calavo Growers (USA), Diamond Growers (USA), Gold Kist (USA) and IAWS (Ireland) [source: Coriolis (2010]. It may also involve introducing outside shareholders and shares may be traded publicly

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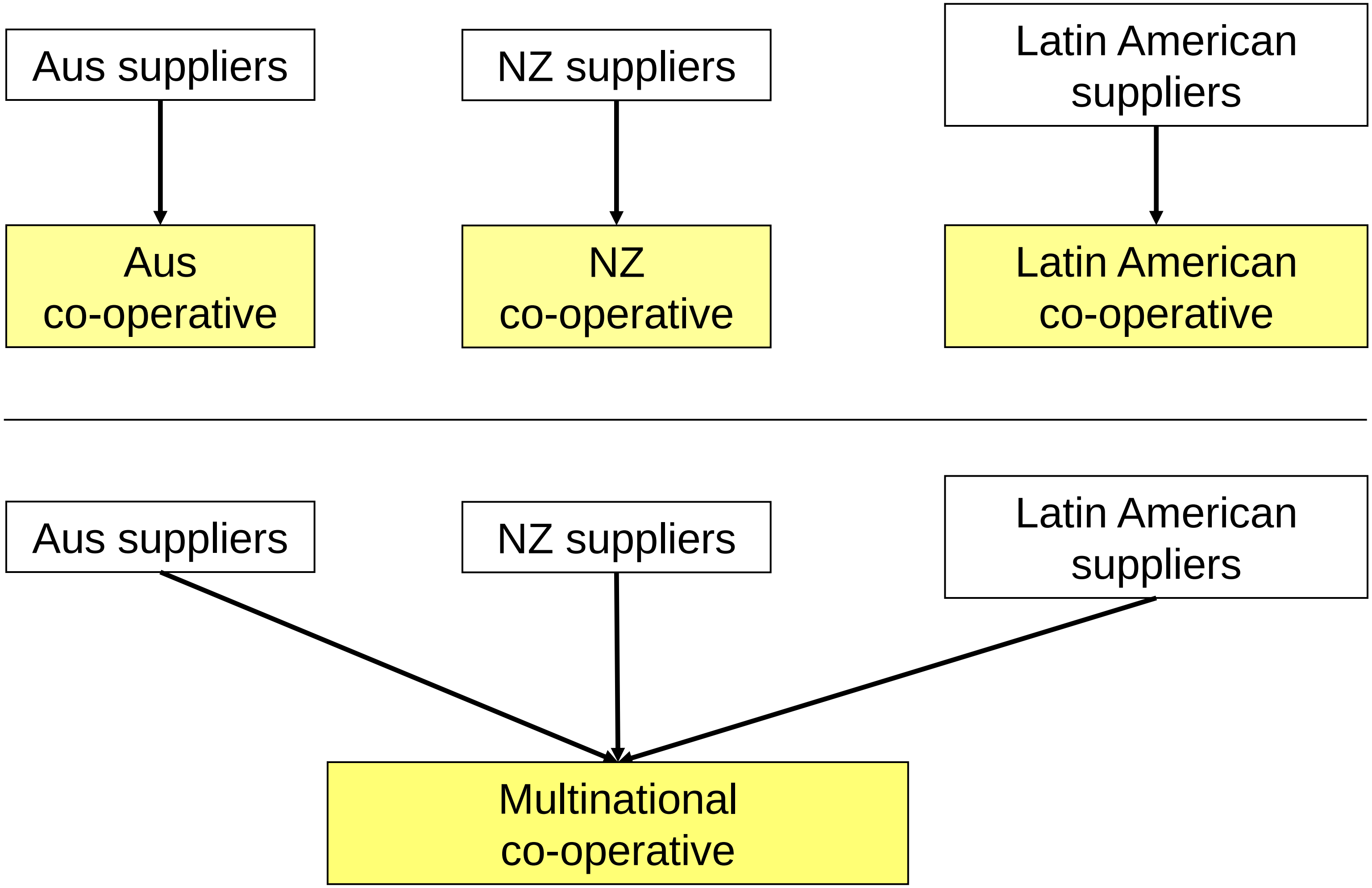
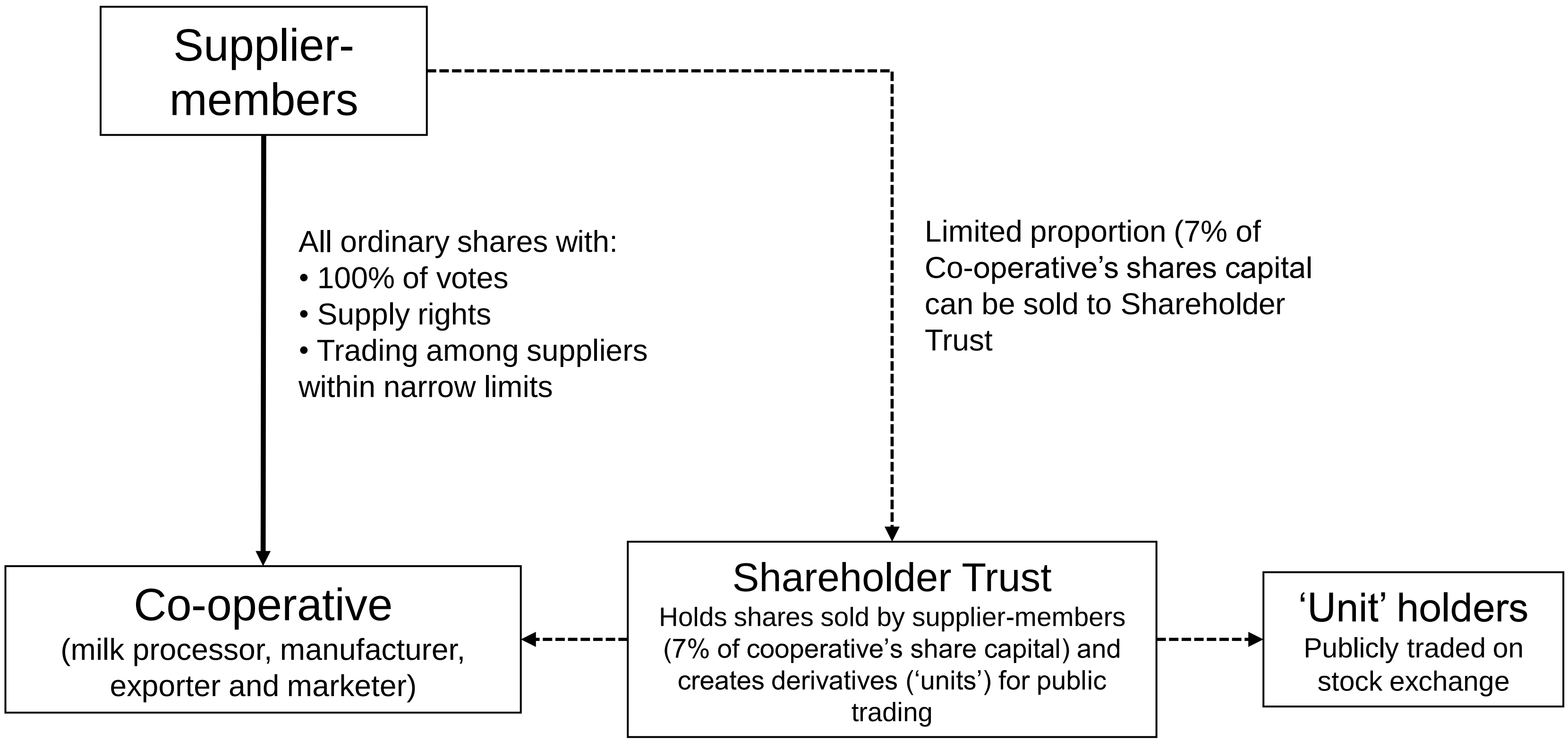
Multi-national co-operative



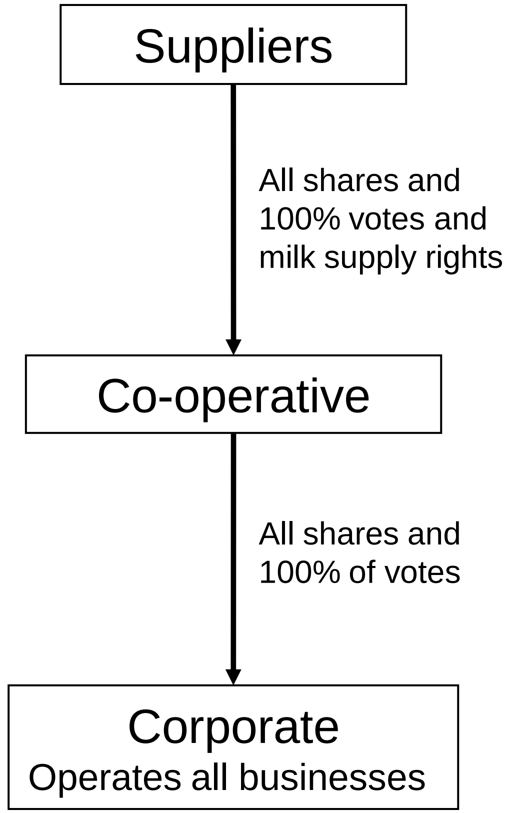
Arla Foods is a multinational co-operative formed in 2000 by a merger between Arla (Sweden) and MD Foods (Denmark).

Fonterra



This does **not** involve the introduction of any new share capital

Corporate owned by co-operative



Creation of FrieslandCampina:

In 1997, four Dutch dairy cooperatives merged to form Friesland Coberco Dairy Food. In 2004, it was renamed Royal Friesland Foods.

Campina was also a Dutch dairy co-operative. In 2004, it planned to merge with Arla Foods, a larger Danish-Swedish dairy cooperative, but the merger did not proceed.

Friesland and Campina merged in 2008.

This structure is used by **FrieslandCampina.** It does **not** involve any outside capital.

Note that the majority of all major marketing cooperatives in the Netherlands have ‘lowered’ their commercial activities into limited liability company structures, but have retained 100% cooperative ownership [source: Bekkum, O.F. van, and J. Bijman 2006] .

Copy Kerry?

Kerry Group is an extremely successful example of a dairy co-operative that transformed itself into a diversified food business listed on the stock exchange – see http://www.kerrygroup.com/docs/history/Corporate-History-15-2-16.pdf

Changes in the Kerry Co-operative's share of Kerry Group and the market value of its share are shown below

1974		1986		2004		2016
100% of Kerry Co-op		51% of Kerry plc		31% of Kerry plc		14% of Kerry plc
€1.25 mn	⇨	**€40 mn**	⇨	**€1,007 mn**	⇨	**€1,548 mn**

Copy Kerry? *(cont'd)*

Kerry Group is often cited as an example Fonterra should follow. Fonterra's directors proposed a Kerry-like capital restructuring in 2007, but it was roundly rejected by dairy farmers.

As Denis Brosnan, Kerry's highly successful former CEO, reflected:

> "..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..."

Copy Kerry? *(cont'd)*

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

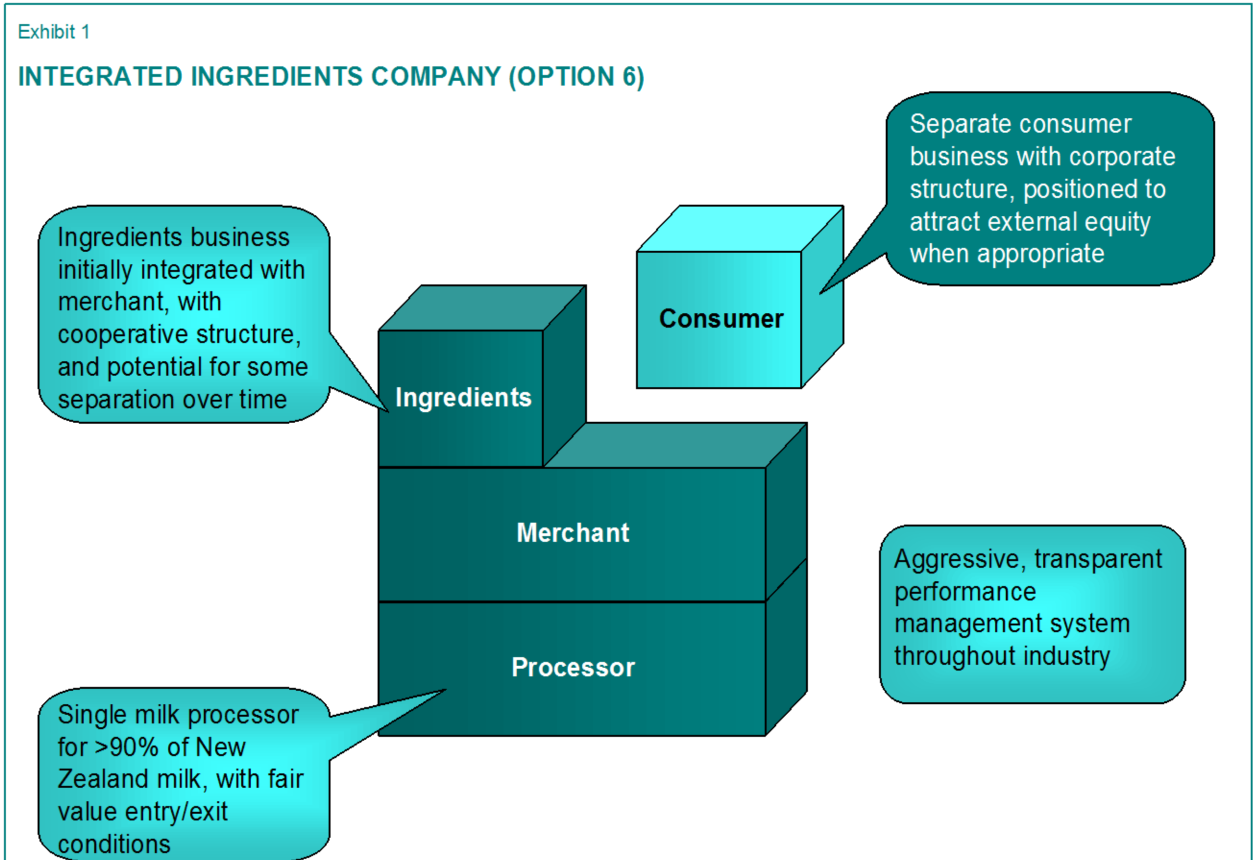
> "If one ever wishes to follow the [public company] route, it will first be necessary to have a change in philosophy before changing the structure, not visa versa…"

Fonterra has not diversified and only timidly evolved its philosophy.

1999 and 2001 merger plans

1999 Plan

The 1999 mega-merger plan for the New Zealand industry included separating the ‘consumer’ business into a separate company with outside shareholders. The ingredient business could also have been separated over time



Source: McKinsey

1999 Plan

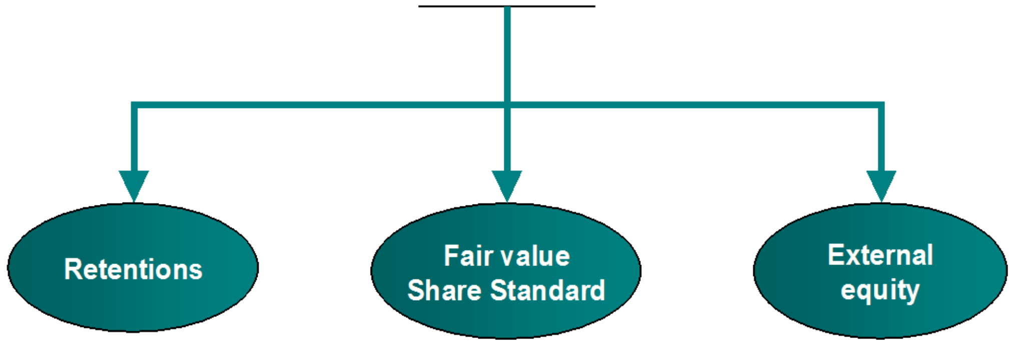
The 1999 mega-co-op plan also included raising an additional $4 billion in shareholder funds – some of it from outside investors

Exhibit 4

CAPITAL REQUIREMENTS AND SOURCES

NZ$ Billions

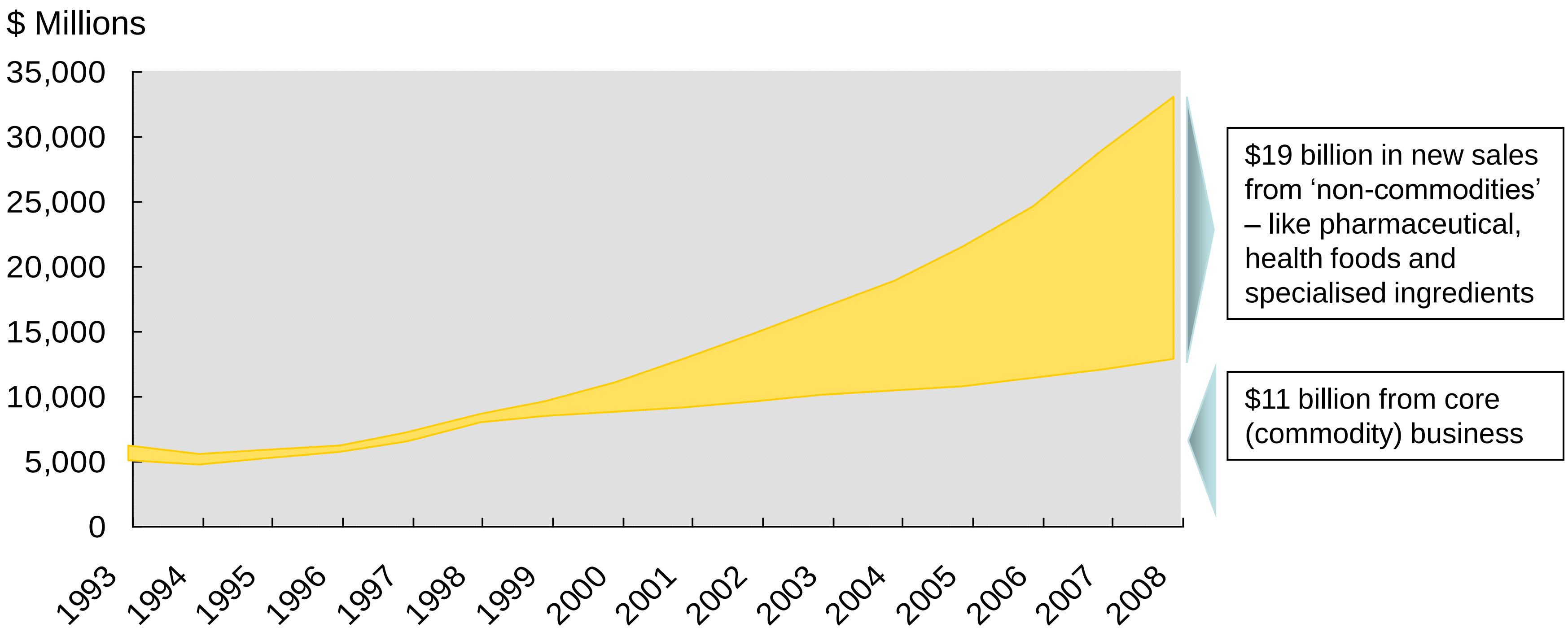
Total capital required	12
Less debt capacity	8
Additional capital required	**4**



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

- In relation to the Global Co proposal (which became Fonterra), consultants to MAF, 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…."

- Fonterra has not raised any share capital from non-supplier-members.

- Fonterra's capacity is constrained by its limited access to additional share capital, which currently comes from two sources: farmer-shareholders buying more shares to match any growth in their milk supply, and retained earnings (just $200 million has been retained over last two and a half years despite significant growth).

Co-operative form

Co-operative form

- In legal terms, a cooperative is simply an incorporation by which many people act as one
- The cooperative form is a perfectly valid vehicle for doing business. It has pros and cons that should be evaluated objectively by shareholders in selecting the structure that most effectively enables their business objectives
- Structure should follow strategy. Some strategies can be best achieved by cooperatives
- To quote Bengt Holmstrom, Prof of Economics at Massachusetts Institute of Technology(MIT):

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

New approaches

A variety of hybrid forms are emerging in response to pressures requiring the co-operatives to adapt to changing market pressures

Traditional producer co-op	Variations in hybrid producer 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	• Some delinking or 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’

Control v ownership

100% (exclusive) dairy farmer ownership is a paramount and deep-seated requirement of Fonterra’s supplier-shareholders.

However, as Prof Bengt Holmstrom of MIT 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

Vertical market issue

- Structural choices in our dairy industry have been strongly influenced by claims or perceptions relating to ‘vertical market failure’.
- ‘Vertical market failure’ relates to the risk that, in some market configurations, sellers of rapidly perishable products that cannot be transported to alternative buyers may not receive a fair market price for their goods because the buyers may ‘hold out’ on the sellers.
- It also relates to the risk that, in some market configurations, the sellers could ‘hold out’ on the buyers, who have invested in very specific assets.
- In short, ‘vertical market failure’ is to do with relative bargaining strength of buyers and sellers of certain products, and the allocation of risk between them.
- Co-operatives are seen as a way of solving those ‘hold out’ risks. In short, the sellers vertically integrate – that is, the producers of perishable goods create and own the buyer of their goods (a cooperative), and their ownership is held in proportion to the volume they supply.

Vertical market issue *(cont'd)*

As Lew Evans and Richard Meade put it (Feb, 2006) –

- Cooperatives tend to arise more naturally where multiple, small and competing producers of a product face market power due to industry concentration further downstream in their supply chain, particularly where product perishability exacerbates their exposure to such market power. Additionally, what is required for cooperative development is a strong homogeneity of interest among cooperative owner-patrons, such as that facilitated by product homogeneity (as is the case for milk), and cultural homogeneity and stability (as is often the case in rural communities).

Vertical market issue *(cont'd)*

Evans and Meade again –

- "Cooperatives are a type of institution, being a distinct organisational form lying somewhere between a spot market and vertically-integrated firm. Left to their own devices, institutions will evolve in response to changing market imperatives, representing a balancing of the relative costs and benefits of that organisational form vis-à-vis others"

- "Thus cooperatives might be seen as a natural solution to particular market circumstances – such as when numerous, small farmers compete to supply large, concentrated agricultural processors or distributors (e.g. supermarket chains) having some market power. One organisational form may succeed at the expense of another where its structure offers competitive advantages."

- "Of course, certain organisational forms may also come to dominate others due to obstacles to organisational change – whether natural or artificial – and so the desirability of certain organisational forms coming to dominate others must be assessed with this in mind".

Vertical market issue *(cont'd)*

- The ascendency of producer co-operatives over proprietary dairy processors in New Zealand (which occurred between the early1900s and the early 1930s) appears to have been more the result of:
  - Heavy influence from Government actively fostering co-operatives and encouraging farmers to leave proprietary processors and create their own co-operative; and
  - Preconceived prejudice by dairy farmers against proprietary processors, which historians agree was unfounded.
- The rise of dairy co-operatives does not seem to have been related to actual or perceived 'hold out' practices by proprietary processors against dairy farmers (or even the risk of it occurring).
- This is outlined further in an accompanying set of slides **– 'Dairy Industry – History'** – at slides 15 to 26

Vertical market issue *(cont'd)*

- Vertical integration tends to occur when it the barriers are too high for sellers and buyers to agree by contract how to allocate risks and rewards. This does not seem to have been a key factor in the rise of co-operatives in our dairy industry in the first part of the 20th century.

- It would seem that all the conditions of 'vertical market failure' were not in place in the industry's early days when co-operatives became ascendent.

- Cooperatives appear to have displaced proprietary processors for others reasons more to do with prejudice and Government incentives. This was further entrenched over time by regulatory structures and pricing systems between the Government , or the government-mandated exporter, and co-operatives.

Sources:

- http://researcharchive.vuw.ac.nz/bitstream/handle/10063/3847/MAF_200306.pdf?sequence=1
- http://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/when-and-when-not-to-vertically-integrate

Vertical market issue *(cont'd)*

- A variety of mechanisms other than a co-operative are available for resolving concerns about possible 'hold out' by buyers or sellers of rapidly perishable products.
- There are many relevant examples in industries such as vegetables, fisheries, wine.
- In some sectors involving highly perishable goods with fragmented sellers, buyers (processors /exporters) will agree a price in advance and assume the market price risk.
- This occurred in the early days of our dairy industry when proprietary processors were its main-stay. As historian H G Philpott points out: "One can scarcely overestimate the courage with which those early proprietors staked their scanty capital against a very doubtful return, well aware of the risk involved".

Vertical market issue *(cont'd)*

- "While admitting the force of the cooperative movement…, one should not forget that the industry owes much to the enterprise of the factory proprietors. When so-called cooperation had started the factory system and brought it to a standstill through bad management, it was the 'syndicator' who stepped in, bought up the discredited factories and built new ones, offered the public a fair price for their milk and put the industry on a sound financial basis.“ - 1897 report of the Department of Agriculture

- By dint of farmers' preconceptions and government regulatory arrangements, alternatives to co-operatives were, in effect, 'foreclosed' for most of the last century.