Future structural options

Tony Baldwin

www.tonybaldwin.co.nz

August 2016

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**.

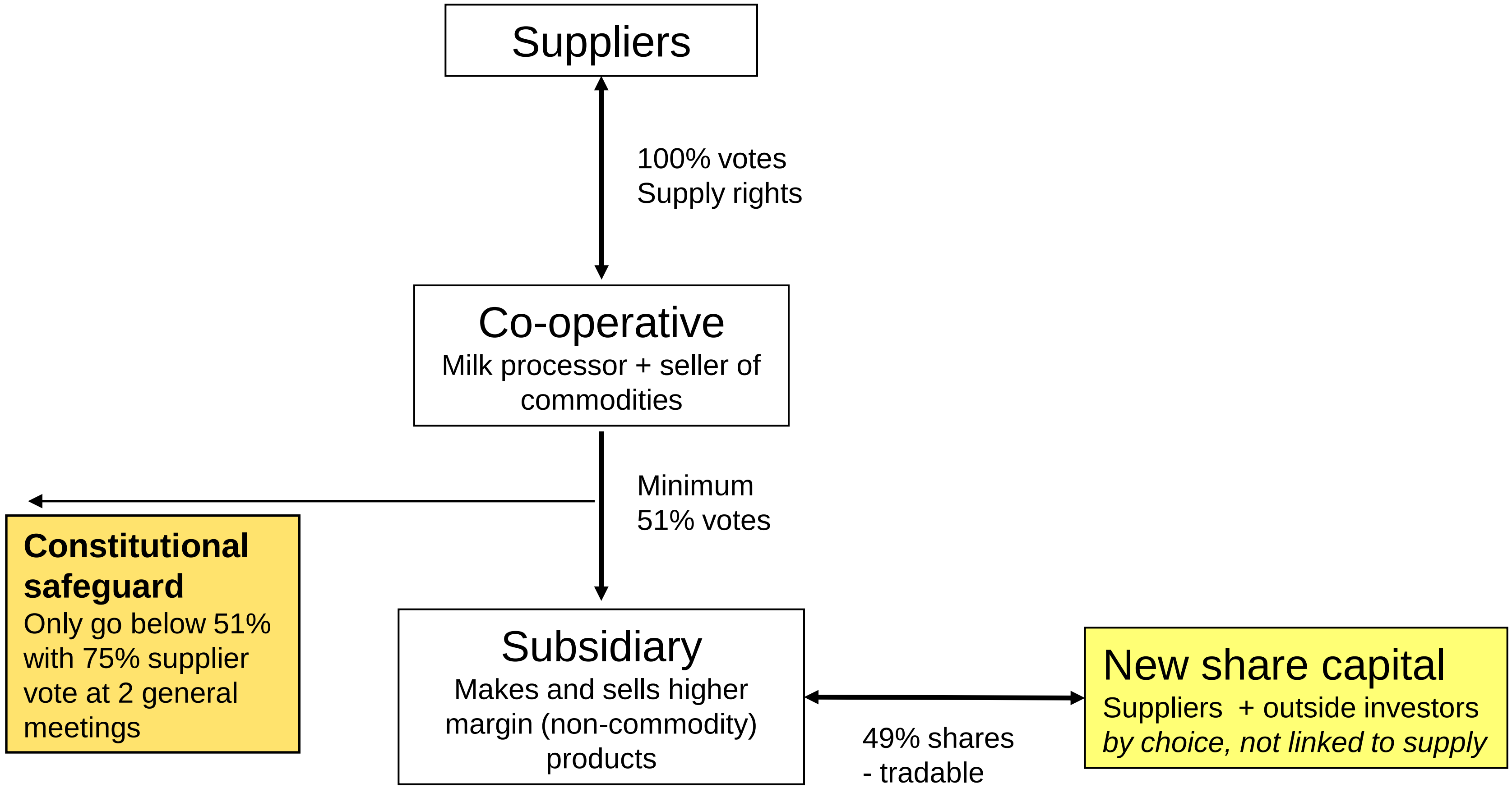
The Kerry Group example is in slides **12 to 14**

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**,

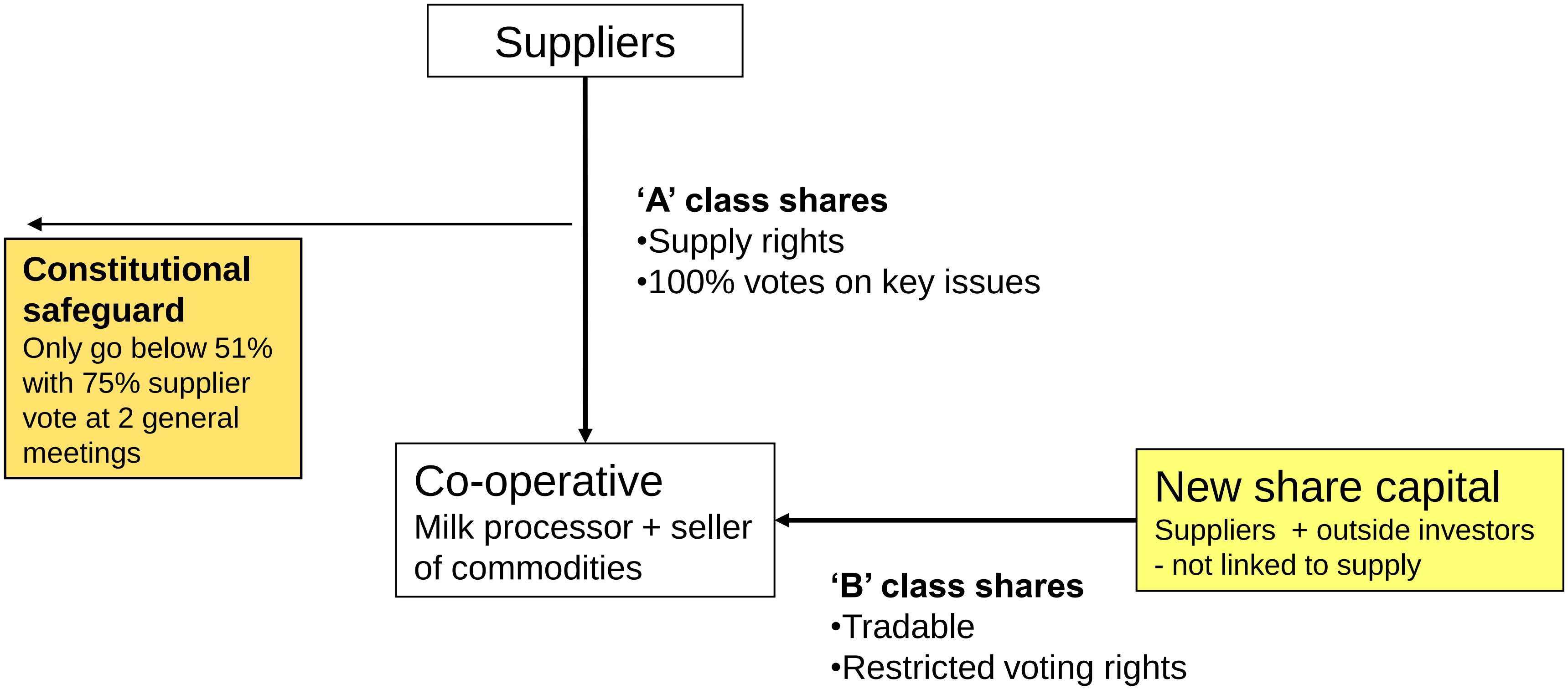
Caveat: These are brief overview slides and do not purport to provide detailed analysis

Subsidiary with outside shareholders



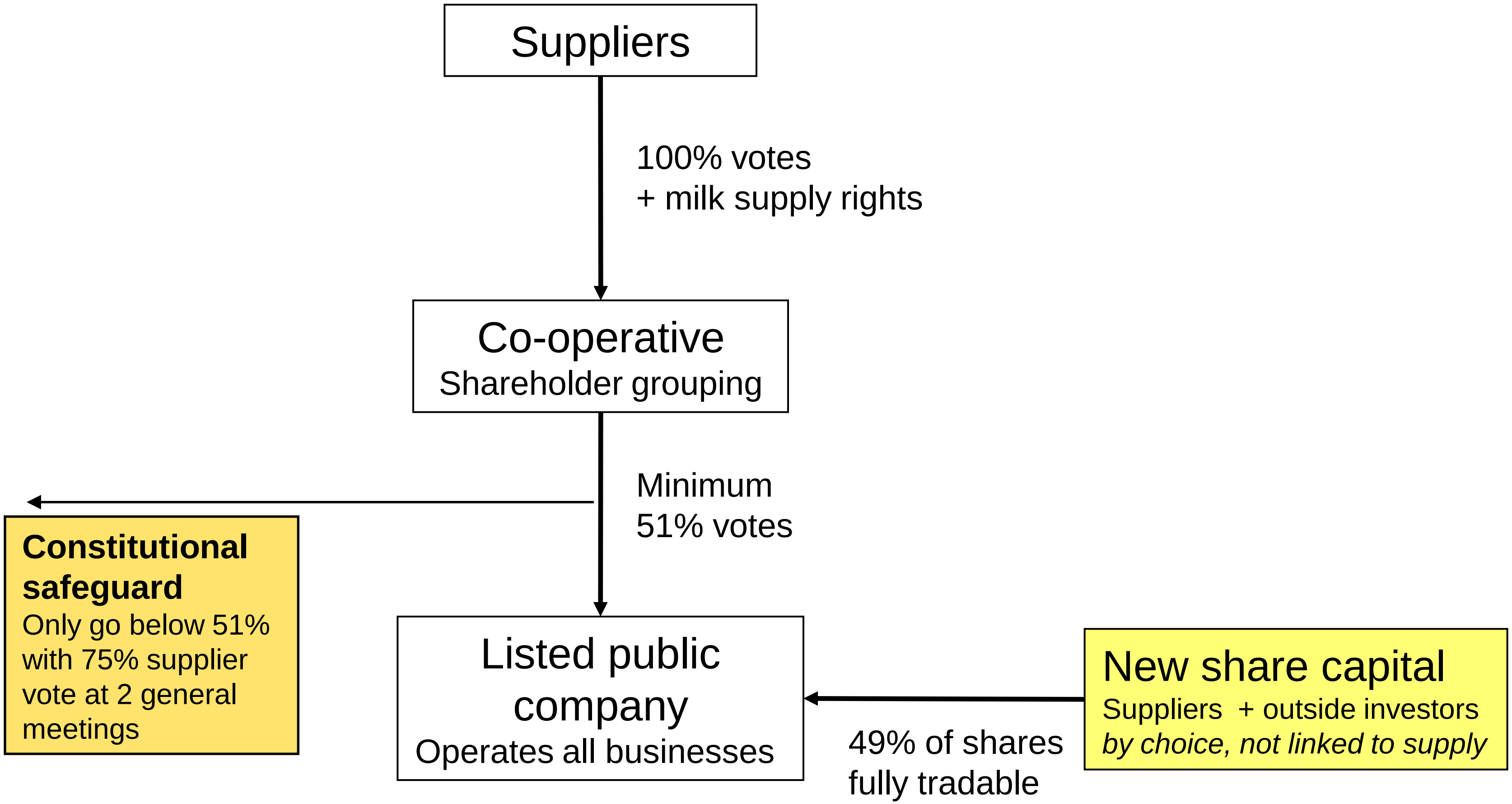
A model like this has been used by three agricultural cooperatives from Finland. Dr Zwanenberg, a prominent co-operative consultant, has advocated this type of model, which may also involve listing shares in the subsidiary [source: Bekkum, O.F. van, and J. Bijman 2006]

Co-op with outside shareholders



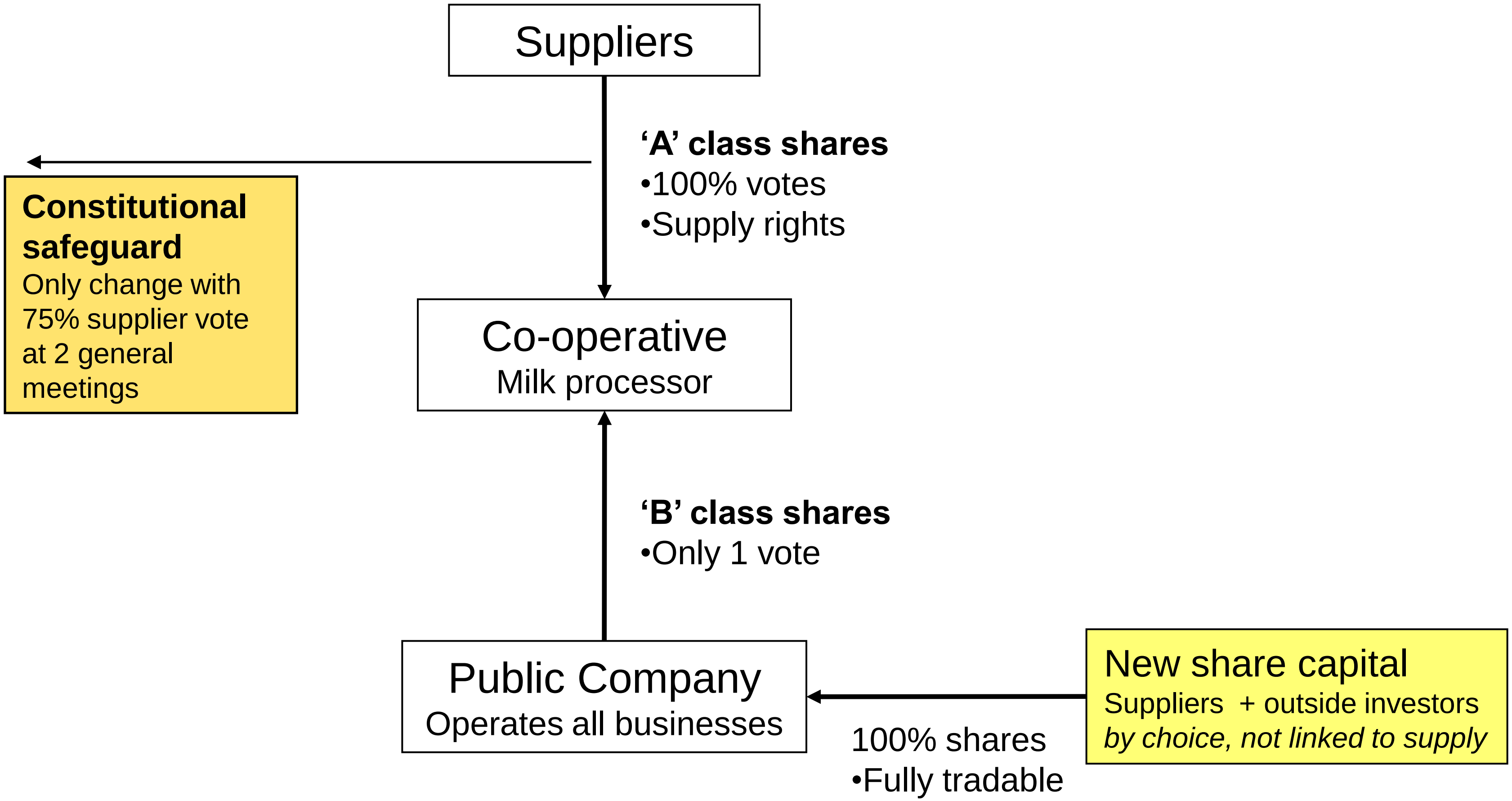
An 'A' and 'B' share structure was used by Air NZ for a period. It is currently used by the Livestock Improvement Corporation. Other co-operative examples of a two-tiered share structure include like Dairy Farmers of America (USA) (2004) and Clover Dairies (South Africa) [source: Bekkum, O.F. van, and 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



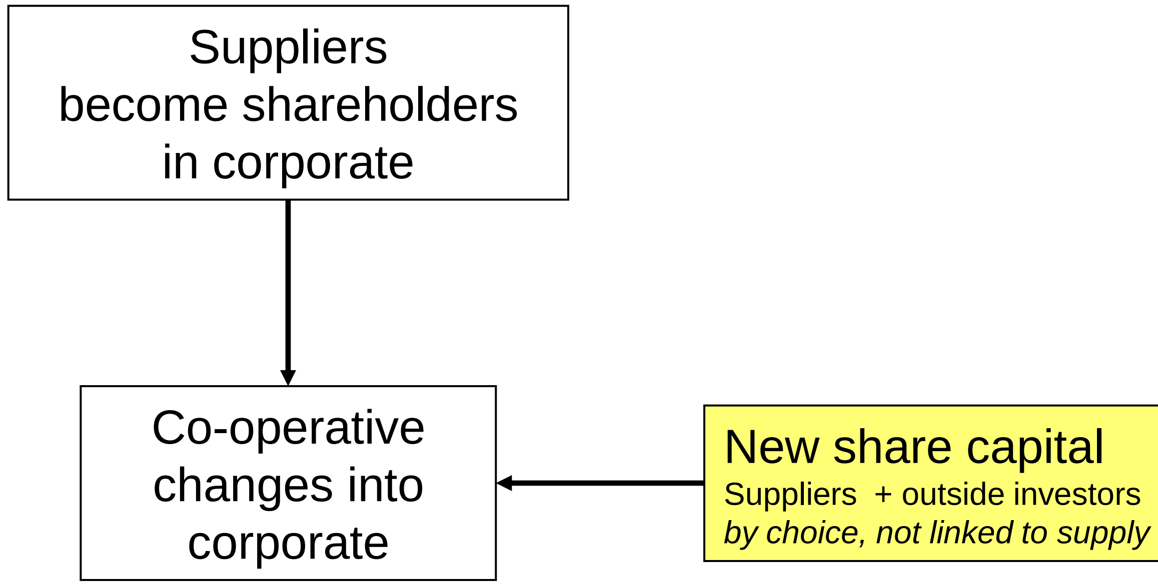
This structure was used by Kerry Group plc and Glanbia plc (Ireland). The Kerry Co-operative's shareholding in Kerry Group has been progressively reduced by special vote of the cooperative's members. Kerry Group's impressive history of growth and diversification is at www.kerrygroup.com/docs/history/Corporate-History-15-2-16.pdf

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

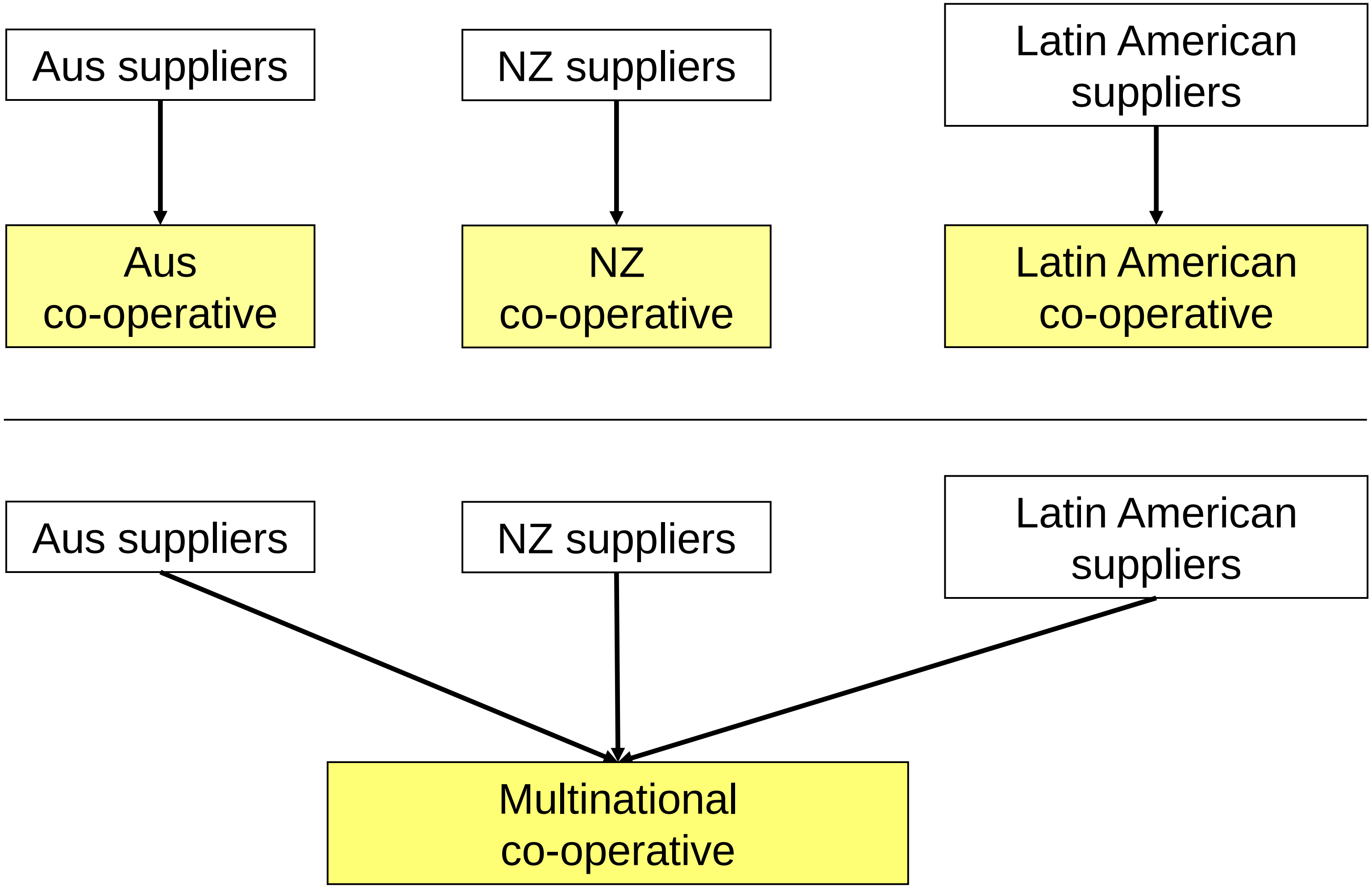
Corporatisation of co-operative



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

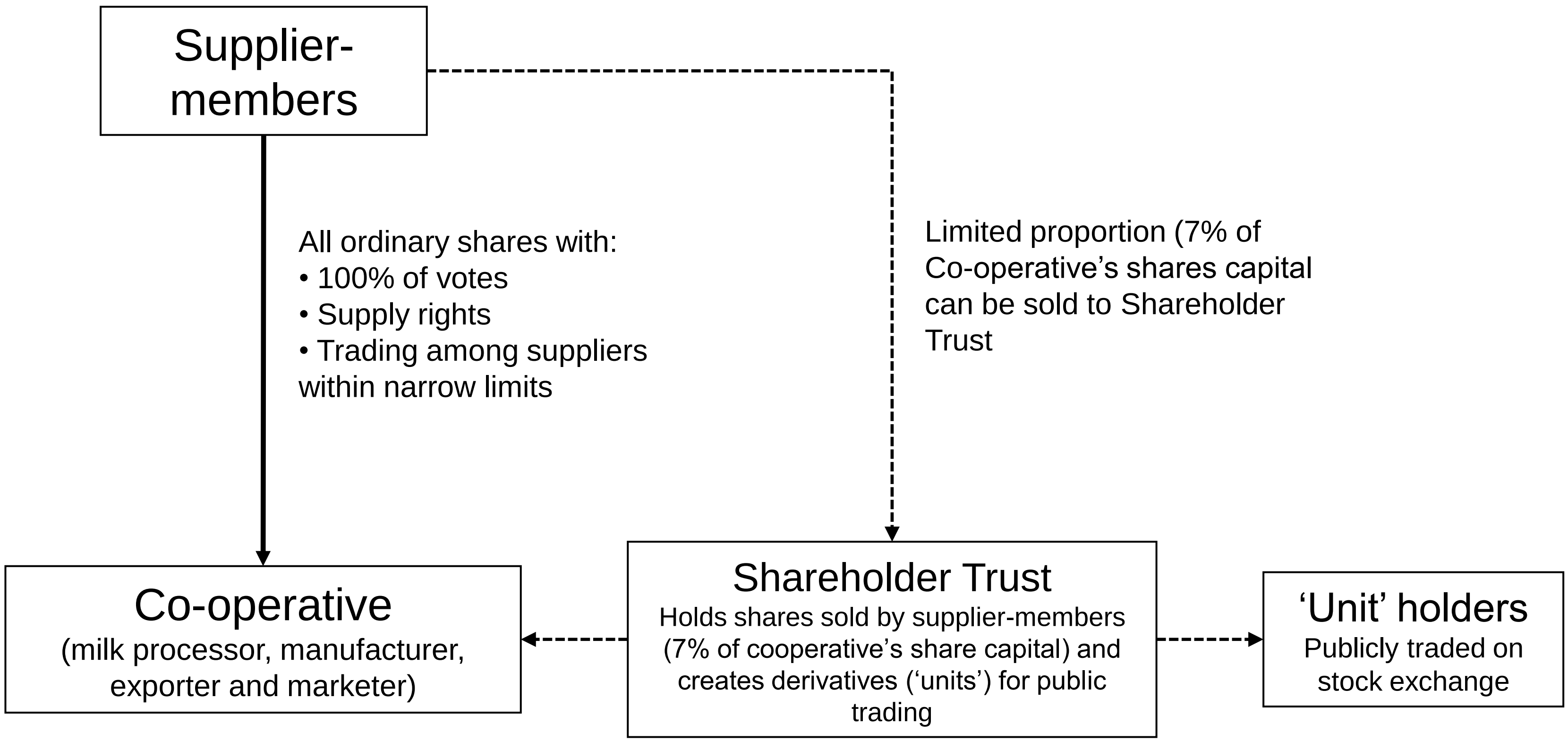
.

Multi-national co-operative



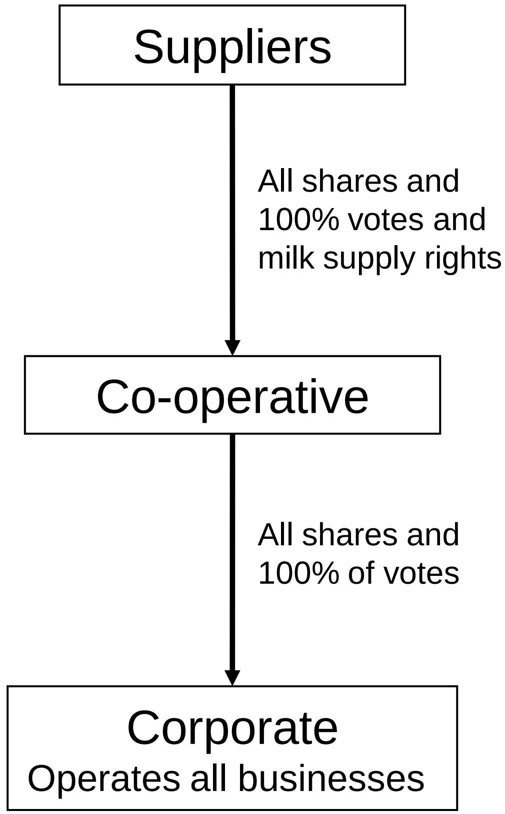
Arla Foods is a multinational co-operative formed in 2000 by a merger between Arla (Sweden) and MD Foods (Denmark).

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…"

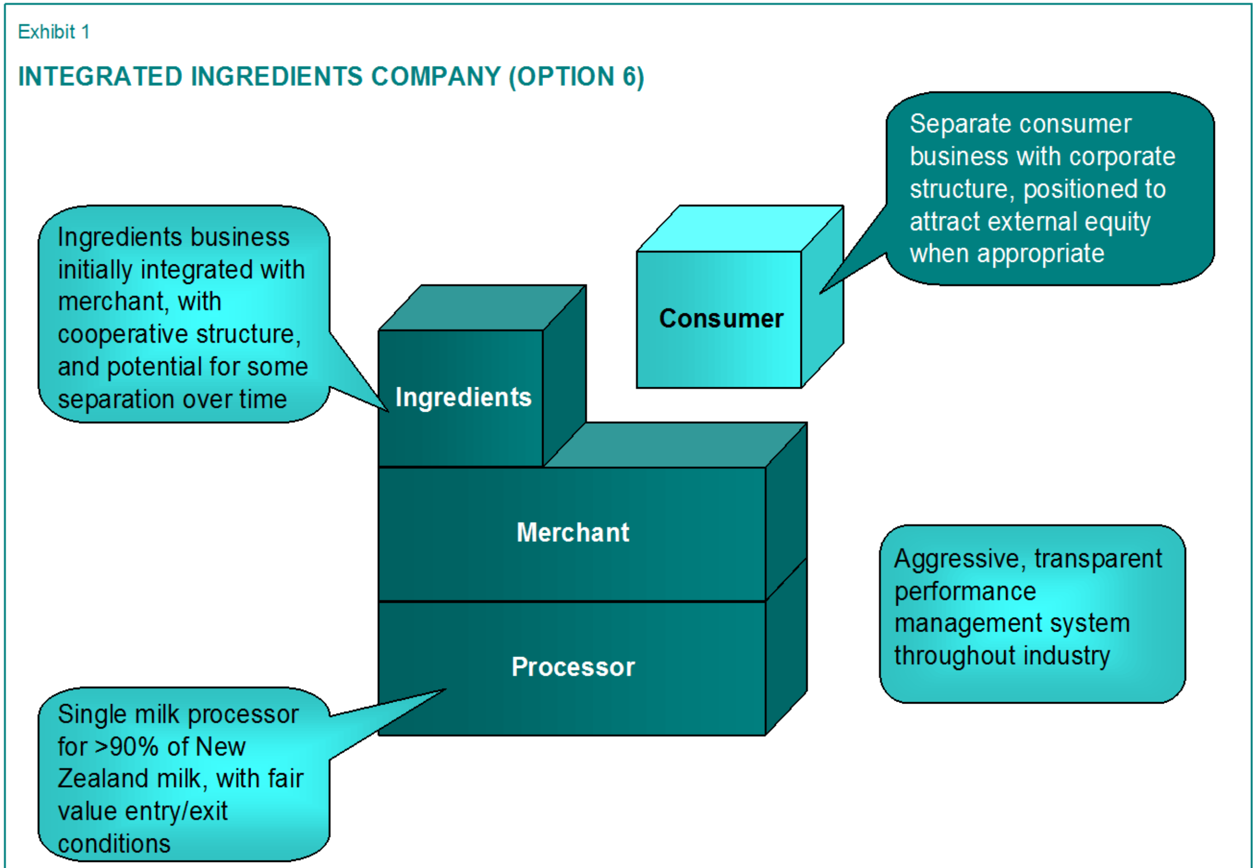
> "If one ever wishes to follow the [public company] route, it will first be necessary to have a change in philosophy before changing the structure, not visa versa…"

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

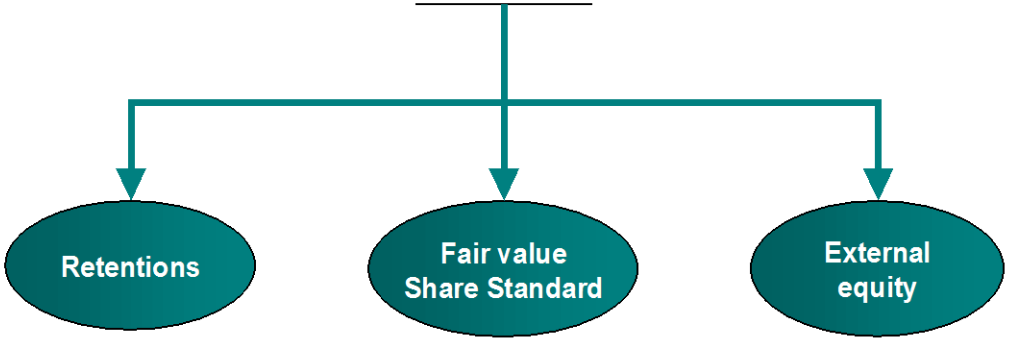
The 1999 mega-co-op plan also included raising an additional $4 billion in shareholder funds – some of it from outside investors

Exhibit 4

CAPITAL REQUIREMENTS AND SOURCES

NZ$ Billions

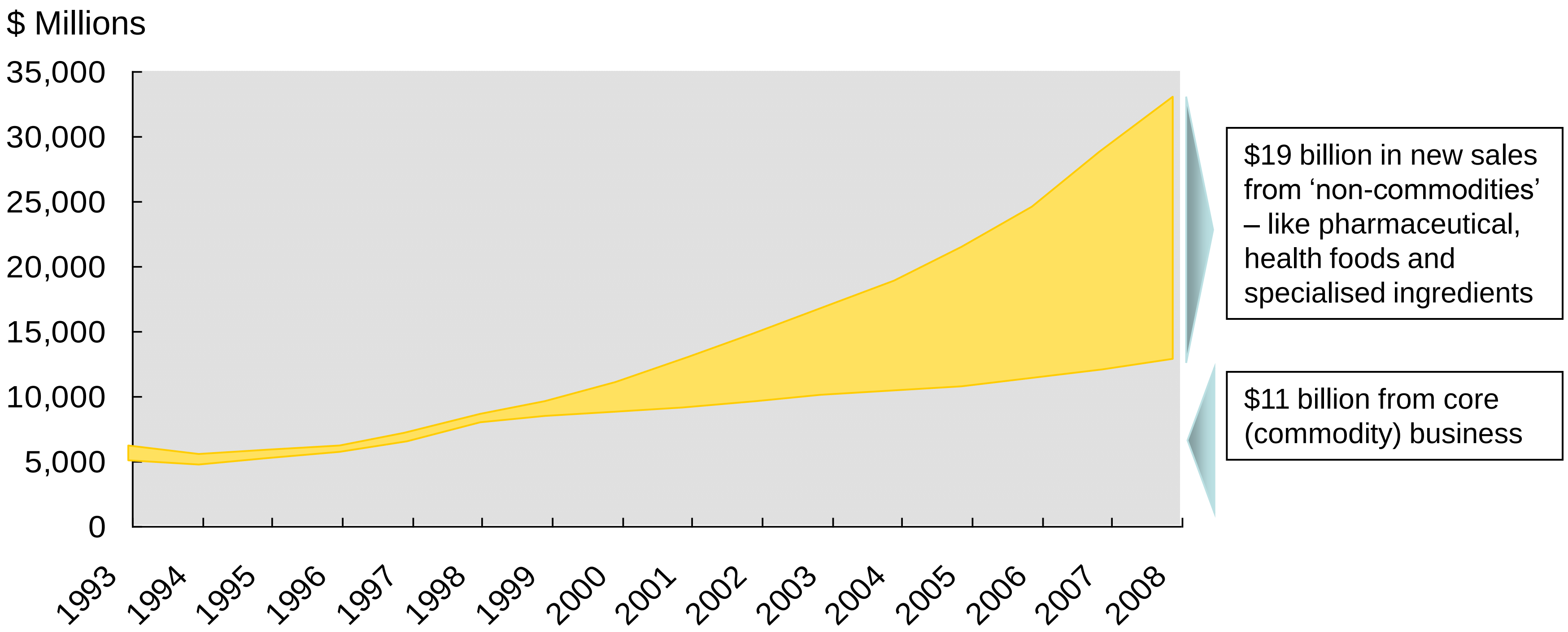
Total capital required	12
Less debt capacity	8
Additional capital required	**4**



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…."

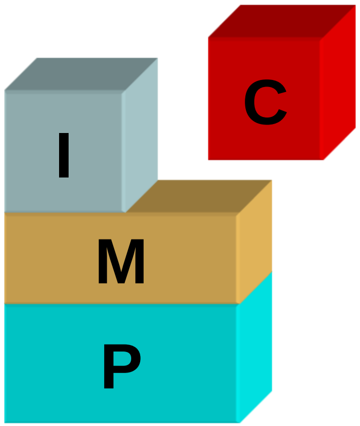
- A comparison of Fonterra's 2001/2 strategy relative to the goals of the 1999 plan shows that they are substantially the same

2001 Plan

- 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 [as at Aug 16] despite significant growth).

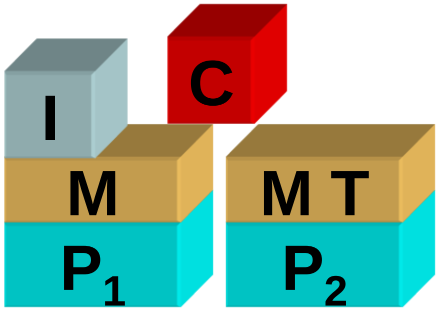
Two competing cooperatives v One mega



OPTION 6

Single mega cooperative

In the lead up to forming Fonterra, McKinsey & Co advised that, if the monopoly-like costs could not be eliminated, **two competing co-operatives** would be preferable to a single mega co-op by $300 million.



OPTION 3

Two competing cooperatives

SUMMARY

Option 6 is preferable to a pure Option 3 by $800 million if x-inefficiency can be eliminated

Otherwise a pure Option 3 is preferable to Option 6 by $300 million if breakdown of Option 3 can be prevented

We believe that the x-inefficiency can be managed under Option 6

Project Structure - 59 -