Capital Structure and Trading among Farmers

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1. Introduction

Having read the various documents on "Capital structure and Trading among Farmers", I am left with some important questions and doubts. It was a similar feeling of unease that caused me to write a letter on Fonterra's strategy to the Board a year ago.
Therefore a second letter to explain my unease this time.

I would like to start by summarizing last year's comments on Fonterra's strategy and link these to the 'Trading among Farmers' issue. Then I shall address the concept of the Fonterra Shareholder Fund, specifically the share price, the relationship to the milk price and the angle of the so- called 'friendly Fund investor'. After a short note on possible implications for share milkers, I shall argue that the concept of 100% farmer ownership has consequences that have not been fully explained in the Board's proposal.

2. Fonterra strategy

In my letter to the Board dated 18 May 2009 I derived the following strategic focus for Fronterra:

Build upon our existing skills in cost-efficient milk operations, dairy food technologies and business-to-business marketing in order to become a globally leading dairy commodity and ingredients business.
Develop those existing consumer businesses that support this goal, that could defend that position and that are fitting for a New Zealand based company; Australia and New Zealand (ANZ) are the obvious examples.

Obviously, the strategy as outlined above leaves many questions unanswered.
In the same letter I identified four building blocks as a possible contribution to answering those questions.

Equity base and retention
I argued for a clear dividend and retention policy that makes very explicit which part of potential pay-out will be retained annually in order to secure the base for future pay-outs. That issue has been addressed head-on since then.

Flexibility in strategy
I drew attention to the view that strategy should not be cast in tablets of stone, but should consist of modules that can and often should be substituted in order to successfully survive in a rapidly changing market place.
I am sorry to say that I have not seen much movement in this area. It seems that the Board has not addressed the important and looming question of which part of the Consumer business has to be sacrificed in order to fund expansion in the Ingredients business.

Behind borders
Last year I criticized the "Behind Borders" strategy for being opaque which is unfortunately a point that remains valid today. My main worry continues to be that the "Behind Borders" strategy has no boundaries, which will lead to a Fonterra 'unleashed and unlimited.

Supply chain
New Zealand's strongly seasonal production and the requirements of continuous supply to major customers still seem to translate automatically in a strategy of investment in diverse physical supply chains across the world as the latest example in China is showing. I would be interested whether alternatives such as preferential trading or investment in logistics have been considered.

3. <u>Trading among farmers</u>

The main motive behind the Trading among Farmers proposal is to develop a stable equity base for Fonterra. That is to be supported whole-heartedly.
The flanking mechanisms such as the introduction of dry shares, annual profit-retentions and the setting up of a Shareholders Fund, therefore, make strategic sense.

It should not, however, deflect from the open strategic questions outlined above. A stable and, hopefully, growing equity base is not an objective in itself. It derives its value from the investments to which it is put to work, the strategy upon which these investments are based and the risks against which these investments have been assessed.
From my point of view, that strategic exercise has not been fully worked out.

4. <u>Shareholders Fund</u>

From my understanding of the proposal of the Shareholder Fund, I perceive three problems, which I discuss in detail below:

- The share value/price of a fully owned share seems to be equal to that of a share with only the right to receive dividend.
- The relationship between the milk price received by a farmer on a "Fund held" share and the milk price received by an exiting or incoming farmer on a not fully paid-up share has not been explained and, therefore, probably, has not been fully thought through.
- The attractivity of a Fund unit for a potential investor has not been assessed properly – at present the main attraction seems to be 'being called friendly'.

4.1 *Share value/price*
A Fonterra share entitles the owner to:

- The right to supply milk and receive a competitive milk price
- The right to vote
- The right to receive dividend and any other form of capital pay-back including at time of liquidation
- The right to receive, and the obligation to carry the risk of, changes in the share value

The price of a share at any given moment would reflect the total expectations of these 4 rights by any vendor or buyer. If, in the case of a Fund held share, the last two rights are split off from the originally homogeneous share, then the remaining two rights of milk supply and vote would still constitute –considerable- value. So a Fund held share, by definition, cannot have the same price as a fully homogeneous share. It must be lower.

The proposal seems to stipulate that the price a farmer receives for his share delivered to the Fund and the price that he will pay the Fund upon repurchase of the shares would both equal the share price of a fully homogeneous share traded at the same day. In a free market that can never happen.

4.2 Relationship of partial shareholding to the milk price received by the farmer
The Board's proposal creates the opportunity for incoming and exiting farmers to acquire or sell their shares over a period of 3 years. This does not come for free, though – and rightly so. The milk price for production on not yet fully paid shares will be lower than the Full Share-backed milk price. The difference would reflect the capital cost involved for the Full Share-backed production plus a little margin in order to encourage rapid full payment, I presume.
I have not been able to find in the Board's proposal on what that difference will be and how it will be calculated.

Another missing link is the similarity between the situation of the not yet Full Share-backed production in that 3 year cycle and the situation of the Full Share backed-up farmer who has sold part of his shares to the Fund.
That latter situation resembles in many ways, but alas not totally, the former. Both produce part of their milk on the basis of shares that are not fully paid or rather: not paid at all.
The former will receive the "milk price" with a discount. The latter will enjoy the same milk price, but without that discount.
That does not seem fair and it looks as if the proposal has not addressed that particular issue.

To complicate matters even further, the farmer with shares transferred to the Fund does not have to stick to the 3 years period that the incoming and exiting farmer have to adhere to. So he is able to enjoy the benefit of the undiscounted milk price indefinitely.

4.3 The attractivity for a potential investor to buy Shareholder Fund units
If my reasoning is correct, no sensible investor will value a Fund share equal to a homogeneous share. The first one has got fewer rights than the latter; therefore a Fund share must carry a lower value.

Theoretically the value of a Fund share would equal the discounted value of the expected future dividend stream (between zero and any amount positive) plus the difference between the purchase price and the expected selling price upon termination (full range between positive and negative). That value then needs to be corrected downwards for the restricted freedom of the Fund as it is the farmer-shareholder who decides if and when to repurchase the shares.

I assume that hardly any analogies exist in real life, so it does not help much to speculate on the difference in value between a Fund share and a homogeneous share. My suggestion would be to ask a focus group of potential and friendly investors for their opinion. And proceed from there.

4.4 Possible complications
The Board's proposal envisages a maximum number of Fund held shares of 25% of the total outstanding shares.

Suppose that percentage to be reached and assume a few bad years for Fonterra. On paper the Fund unit holders would not have any influence in the decision making process of Fonterra –

remember: no vote for the Fund – but we all know that reality is different. For starters, the Fund itself will be the largest shareholder by far. If unit holders are getting angry and press the Fund into action, the paper no-vote wall will not hold for very long.

What might exacerbate the situation even further is a possible controversy between farmers and outsiders i.e. Fund unit holders. That controversy could easily be fuelled by the farmers' wish to channel as much "profit" as possible in the milk price and forego dividend while the outsiders will demand the contrary.
Rules and procedures are fine in peace time and when the going is good but become very fluid in crisis. Just look at today's Euro crisis as an example.

4.5. Can the Fund solve the redemption issue?
The Board's proposal of the Shareholder Fund is motivated by trying to prevent capital from washing in and out of Fonterra's balance sheet as a direct consequence of changing cash-flow and production situations on-farm.

The introduction of dry shares and profit retentions can certainly make a positive contribution to the redemption issue. But the Board's proposal of a Shareholder Fund cannot yet stand that test. The flaws discerned above need to be addressed first.

5. Milk price and the sharemilker

A separate issue is the position of the sharemilker in different "owner share" situations.

A sharemilker can find himself in three different categories:
- A fully shared owner as all farmers should be today, receiving a full milk price
- An incoming or exiting owner who has not paid up all his shares and therefore receives a lower milk price for part of his production
- An owner who has transferred part of his shares to the Shareholder Fund and receives the full milk price according to the Board's proposal, even though it is questionable whether that is fair.

I have not gone into complications that these various circumstances will undoubtedly cause. The issue should be addressed, however, before going forward.

6. Conclusion

The Board is trying hard to conceive a structure that would create a stable and growing equity base for Fonterra. That is fundamental to whatever growth strategy will be envisaged and it is the logical outcome of the wish to continue on a 100% farmer owned basis.

Fonterra is struggling with the issue for quite some time and in my view trying to square the circle.
If farmers themselves do not supply stable funds for the growth of the business, then one needs to look elsewhere. But if "100% Farmer Owned" is the ultimate parameter, one cannot look elsewhere.
Any outsider –friendly or not so friendly- will ask a price that includes influence on how his money is spent.

The presently proposed Shareholder Fund tries to introduce outside capital in a way that is consistent with “100% Farmer Owned”. But I have argued that the present set-up does not actually meet that standard, or won’t meet it for very long.

The bottom line is that the availability of stable equity will dictate Fonterra’s strategy. If farmers do not want outside capital – and let me emphasize again that I support that policy- then Fonterra needs to grow in line with the funds supplied by farmers: production backed shares, dry shares and profit retentions.

That, in turn, will force Fonterra to make sharper strategic choices than its management would possibly prefer: choices that would include divestments of businesses in order to fund even more promising businesses.
In summary: Fonterra’s challenge is not to square the circle on the redemption issue but to devise a coherent and viable business strategy on the basis of 100% farmers funded equity.

7. <u>A final word</u>

As stated in the beginning I have doubts about the proposed “Capital structure and Trading among Farmers”. With a personal stake in the company, I felt that I should translate those doubts into a positive contribution to the company.

I realize that a conceptual exercise as above tends to focus on what is supposedly wrong instead of right. Let me therefore repeat that Fonterra has great value and is a company to be proud of, and that this letter is not meant to take away from that.

I would welcome any feedback or further discussion on the above, and would be happy to be of assistance where I can.