To: Board of Directors of Fonterra: Henry van der Heyden

Cc: Fonterra Shareholders Council: Blue Read

18 May 2009

<u>*Concerns: Fonterra's Strategy*</u>

Dear Henry,

This letter finds it origin in a certain amount of unease that I am experiencing about Fonterra's current strategy. As a shareholder with some background in strategic management, I felt it incumbent to explore these worries in some detail. The result of that exercise is this letter, which I hope, can make a constructive contribution to Fonterra's long term future.

I only joined Fonterra recently as a shareholder-supplier, in June 2006. I was first exposed to Fonterra's strategy decision-making process during the "Capital Restructuring" discussion, which started with the Board's November 2007 proposal outlining its preferred capital structure that would open shareholding to non-farmers.

When I read that proposal I intuitively felt that the logic behind it contained some flaws. I found these intuitions confirmed, as well as articulately argued, in Keith Woodford's 2 January 2008 discussion paper.

Since I never read any comment from Fonterra in response to Keith's main conclusions and objections, I have attempted to explore these issues myself more deeply. For that reason I attended Fonterra's "Understanding Your Co-op" course in March 2009, which was very instructive. It contributed to my gaining a much better understanding of the complexities of Fonterra's business; its great value; and the difficult dilemmas that it serves the Board to solve.

It has also provided me with the knowledge that I lacked in order to better substantiate my unease and worries about Fonterra's strategy.

In this letter I shall first summarise Keith Woodford's main conclusions on strategy, followed by my own conclusions on this topic and a brief comment on Nestle. Then I shall address the issue of third-party shareholding in a cooperative that is far more complicated than originally explained. I shall, then, briefly touch upon the managerial challenges of running a fully-fledged international food company from New Zealand. Finally four building blocks will be presented that, in my opinion, will have to be part of any strategy that the Board will decide to pursue.

<u>1. Preferred capital structure: proposal November 2007</u>

1.1 Strategy

I will only briefly summarise Keith Woodford's main objections to the proposal, as I am sure you are aware of the contents of the paper that he wrote.

Before one looks at capital structure one needs to address strategy (Structure follows strategy) and Fonterra's present position.

Fonterra is Number 1 in the world when it comes to dairy commodities, dairy ingredients, and the marketing of these internationally. It is, however, no more than a small player when it comes to global brands and fast moving consumer goods. In the latter arena all major competitors are internationally operating food companies, not dairy companies. These companies build upon their global consumer-marketing and branding strengths; not on the cost-efficient milk operations, dairy food technologies and business-to-business marketing skills that happen to be Fonterra's core competencies. And these international food companies are predominantly focused on return of the capital invested, not on increasing the value and returns that farmers get for their own milk.

Fonterra's "Behind borders" strategy is at least partially, if not completely, based upon the assumption that Kiwi's know at least as much about –say– Brazilian business customs and consumers as either their Brazilian competitors or international food companies such as Nestle. The assumption is that Fonterra, therefore, is equal to these bigger players in assessing risks.

If it weren't for amply available evidence to the contrary, the Sanlu experience has proved the fallacy of that assumption more than adequately

That leads to the preliminary conclusion that Fonterra's present position – as a world-leading dairy ingredient producer, but a merely regional player in terms of consumer marketing – dictates a dominant Business-to-business strategy based upon dairy ingredients, possibly combined with, at best, only a limited, regional and defensive consumer strategy.

If this is not the exact interpretation of Keith Woodford's paper, then certainly it is reflective of my own conclusions on the subject.

1.2 Nestle

Nestle is often mentioned in Fonterra's documents as a so-called analogue company; whilst not similar in size and scope, it is regularly presented as an example to be followed.

This picture is incomplete. It fails to mention that Nestle's Milk/Nutrition/Ice cream business represents only 25% of its total turnover and 20% of total EBIT. The rest of the business depends on Beverages (such as mineral water), Prepared dishes, Confectionery, Pharmaceutical products and Pet foods. So much for this comparison!

1.3 Redemption

The redemption risk was an important motive underpinning the Board's preferred capital structure in November 2007, which allowed for third party shareholding. That proposal is now off the table and we are waiting for a new proposal from the board.

Although the redemption issue is a real issue, I have often wondered why a "slow release" of capital from Fonterra to exiting farmer-shareholders is not an option to pursue vigorously. I am fully aware that present legislation is prohibitive, but why not try to change that legislation?

Surely the cost of those lobbying efforts towards the government and parliament must be small in comparison to attracting third party shareholders on sufficiently favorable terms. I will return to this point in detail further on.

2. Present strategy

Fonterra's current strategy is represented by the jig-saw puzzle diagram that accompanies the three years business plan 2009-2011. It consists of nine interlinked pieces and six priorities.

2.1 Puzzle

Let me start by saying that I am no fan of expressing business strategy as jig-saw puzzles. But that may be a matter of taste.

Nevertheless, even though business strategy should solve puzzles it should not result in a tightly knit structure that does not allow for flexible substitution of the various pieces.

I worry that Fonterra's strategy jig saw is reflective of some degree of rigid thinking about strategy formulation within the company- but I cannot judge this. Either way, I would recommend a more flexible strategy model.

2.2 Ingredients and Consumer

The main objective of Fonterra's current strategy is the simultaneous and considerable expansion of both global Ingredients and global fast moving Consumer products. Achieving these two goals simultaneously therefore appears to present the ultimate challenge for Board and management. I would argue, however, that it presents the ultimate strategic flaw.

Most, if not all, companies over time that have tried to combine these two ambitious goals, have failed. They either went out of business or decided to focus on one of the two goals exclusively. In most cases the focus became consumer products, resulting in the divestment of the commodities/ingredients branch. Unilever and Nestle are good examples of this; they have successfully managed to switch focus towards Consumer goods, but this was a process that lasted several decades.

Judged by these examples, Fonterra's strategy is very risky; even if Fonterra succeeds in building a global consumer and ingredients business simultaneously, this will most likely happen at the expense of its ingredients business. That would leave Fonterra's farmers considerably worse off.

Judging by the Board's recent emphasis on "ring fencing" the consumer business, I conclude that the strategy of rigidly following in Unilever's and Nestlé's footsteps has been abandoned. I welcome that decision and consider it a reassuring first step. The next logical step in focusing on the ingredients business has to be the decision what current consumer operation to sacrifice and sell in order to provide funds for the global expansion of Fonterra's Ingredients.

3. Third party shareholders in a cooperative structure

The redemption issue was an important motive, probably the most important one, for the Board to propose non-farmer shareholding in November 2007. My goal here is not to question whether third party shareholding is in principle a possible solution for the redemption question – it definitely is. Instead I want to argue that in the specific context of a New Zealand cooperative, the allowing of non-farmer shareholders would be a recipe for chaos.

Every business has five important classes of stakeholders: Customers and suppliers on the outside, and owners, management and staff within.

It does not require an MBA to know that the maintaining of a workable balance between the three internal stakeholders in a company is a major challenge in itself. Today's global financial crisis provides some nasty examples.

That balance – between owners, management and staff – requires regular attention as well as difficult compromises; in any company, anytime. It is often also loaded with multiple layers of emotion.

By contrast, in the managing of outside stakeholders, such as suppliers and customers, it is far more likely to expect rational behavior.

A cooperative has the added charm -or complication- that its owners have the dual role of also being by far the most important suppliers. What in a "normal" company is the outside stakeholder, in a co-op becomes the inside shareholder. I do not have to tell Fonterra's Board and management what that implies; you are far more aware and much better equipped than I am, to judge the impact of these added stakeholders inside the company. I would imagine, though, that it does complicate decision-making as compared to "normal" companies, and that it may occasionally drive managers crazy. (And they are probably right to feel that way.)

Keeping that in mind, now imagine adding another charming attribute: the outside shareholder. In the case of Fonterra that will most likely be an international shareholder such as an institutional investor from Japan, Dubai, China or Russia (to mention just a few obvious examples). If New Zealand farmers can drive a management crazy, just wait what the mix of Kiwi's and those fellows can do.

Inviting outside shareholders into Fonterra will add another complicating factor to the delicate balancing act that managing a cooperative already is. Instead of creating a stable equity base, the structure will become exponentially unstable. And I have not even addressed the issue of the fair milk price yet!

4. Strategy and organization

In chapter 2.1 I touched upon the Ingredients/Consumer dilemma. From an organizational or Human Resources perspective, however, two more observations need to be made.

First, Unilever and Nestle were mentioned as two companies that successfully made the transformation from a mixed business to a focused Consumer business. As most of you will know, many others have failed. From my knowledge and personal experience, one cause for those failures does stand out: the difference in company culture and staff characteristics that Consumer and Commodity businesses require.

In order to be successful, Consumer companies require a different people from Commodity companies; the relative needs for marketing skill, people affinity, consumer feel, and trend awareness –to name a few- just vary too much.

A resultant danger for a company that attempts to unite both focuses, is that a consumer orientated top management makes the wrong strategic decisions for the commodity business - and vice versa.

A second observation emerged during Greg Gant's excellent presentation at the 'Understanding Your Co-op' course. He mentioned the various obstacles to attracting sufficiently qualified and internationally experienced mangers to Fonterra. Many of them just do not want to live in New Zealand. And if they do, their wives and family may not.

This was an excellent reminder of a basic fact that all of us -including myself- sometimes tend to forget: strategy is not general, it is very specific.

In any strategy proposal it should be imperative to keep these points in mind.

5. Fonterra's four building blocks of strategy formulation

In the previous sections I have tried to logically deduce a suitable and feasible Fonterra strategy that can briefly be described as:

Build upon our 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 and could defend that position <u>and</u> are fitting for a New Zealand based company. Australia and New Zealand (ANZ) are the obvious examples.

I am well aware that the strategy as outlined above leaves many questions unanswered.

For example, should we sell the Chilean business in order to provide funds for the international expansion of Ingredients?

I cannot answer that question as I do not know the particulars of this specific case. What I do know, however, is that some consumer and "behind the border" businesses will need to be sacrificed if and when the choice for a global Ingredients strategy arrives at its implementation phase.

In order to guide this decision-making process I have identified four building blocks.

5.1 Equity base and retention

In every ambitious company sufficient investment funds are always lacking. Fonterra is no exception. The current global financial crisis is making this even more of a problem.

Every "normal "company uses part of its annual profits to fund its expansion through new investment. It retains that part of the annual profit before it pays a dividend to its shareholders. In a co-operative, however, "retention" appears to be a term that should be avoided at almost all cost. I find that a bit bizarre.

It should be communicated – clearly and relentlessly – to farmer shareholders that you cannot have your cake and eat it; every "normal" company of the size of Fonterra has a well-defined dividend policy. I would suggest that the Board develops and aggressively markets to its shareholders an analogue policy for Fonterra that makes very explicit which part of potential pay-out will be retained annually in order to secure the base for future pay-outs.

5.2 Flexibility in strategy

Some authors on strategy formulation claim that this is a crafting process. If that is true –and I subscribe to that view- the Board should make efforts to communicate this. Strategy is not cast in tablets of stone. It consists of modules that can and often should be substituted in order to successfully survive in a rapidly changing market place.

To expand a bit further on the Chilean example above: if it would be decided to sell the Chilean business today, it cannot automatically be concluded that the original purchase decision was a mistake. On the contrary. It may have served its purpose then, just as its divestment will be serving a new purpose today.

5.3 Behind borders

In the first part of this letter I have indicated that the assumptions underlying the "behind border" strategy are questionable at the very least. The most worrying aspect for me is that the "behind borders" strategy does not have boundaries. It will lead to Fonterra unleashed and unlimited.

We are now behind borders in USA, Mexico, Brazil, Sri Lanka and China. Are we going to stop here or further expand into India and Russia in order to complete the BRIC concept?

Even if we do not, how much additional money are we going to invest in USA compared to Brazil or China compared to Mexico?

What activities should we invest in: yoghurt factories, farms or milk logistics?

And what parameters are we going to use to make those decisions?

These are mind-boggling questions that I have not seen the beginning of an answer for yet.

And to be frank, it will be an impossible task to answer those questions correctly unless it is made very clear where Fonterra's focus should be: Ingredients, Consumer or both?

Even then, the "Behind borders" concept remains extremely difficult and tricky to grasp and implement.

I would, therefore, suggest that we put the "behind borders" strategy on hold, for the time being, and would advocate cautiousness in the allocation of additional money for investment in these various existing ventures.

5.4 Supply chain

Globalization of the supply chain is an important part of Fonterra's strategy. I can see the logic behind this, and its argumentation seems to be sound. With New Zealand's strongly seasonal production, reliability of supply to major customers will require other sources of supply.

Global trading does play a role in that respect and I can accept that quality control of supply would require a more intimate knowledge and involvement with foreign dairy operations.

I find it hard to comprehend, however, that this translates "automatically and directly" into physical investment in physical supply chains across the world.

In order to escape the "Behind borders" trap I would suggest looking for alternative ways of securing that quality in supply.

6. A final word

As stated in the beginning I have written this letter out of a feeling of unease with Fonterra's strategy. With a personal stake in the company, I felt that I should translate that unease into a positive contribution to the company.

This has led me to attend the Understanding Your Co-op course, which I greatly appreciated and enjoyed. In turn it has motivated me to think Fonterra's strategic issues through and through, using my theoretical and practical experience in formulating international business strategy. The result is this letter, which I hope can make a constructive contribution to the company.

I realize that a strategic 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 hope to serve one purpose and one purpose only: to make Fonterra even more valuable and to make it even more deserving of pride than it already is.

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

Sincerely yours

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