



## **Market Announcement**

23 September 2021

### **Fonterra Capital Structure Review – Update for Unit Holders**

The attached communication was provided to Fonterra Shareholders' Fund unit holders by the Chairman, John Shewan on 23 September 2021.

#### **For further information contact:**

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## Fonterra Capital Structure Review

### Update for holders of units in the Fonterra Shareholders' Fund

#### Background

Fonterra Co-operative Group Limited (**Fonterra**) released its financial results for the year ended 31 July 2021 today, together with a long-term strategy and details of a revised capital structure proposal that it will discuss with farmers over the coming weeks before deciding whether to proceed to a Fonterra shareholder vote. The materials are available at [www.fonterra.com/capitalstructure](http://www.fonterra.com/capitalstructure) or <https://www.nzx.com/companies/FCG/announcements>.

When Fonterra's Capital Structure Review consultation process commenced in May, FSF Management Company Limited (NZX, ASX: FSF), manager of the Fonterra Shareholders' Fund (the **Fund**) formed a **Subcommittee**, comprising its three independent directors, to consider the implications of the Capital Structure Review for the Fund and unit holders. This update provides the Subcommittee's views on the latest revised proposal, which Fonterra calls **Flexible Shareholding**, and outlines the work the Subcommittee has undertaken in representing unit holders' interests.

#### Fonterra's current proposal is that the Fund be retained

Fonterra's current proposal is that the Fund be retained, but that its size be capped. Fonterra farmers would no longer be able to exchange the economic rights relating to Fonterra shares into units in the Fund. Farmers holding units in the Fund would continue to be able to exchange them for shares in Fonterra. This means that the Fund may reduce further in size over time.

When consultation on the Capital Structure Review started in May, Fonterra outlined two possible options for the Fund; the one it is now proposing or an alternative of offering to unit holders to buy back the Fund. At that time, it had reached a preliminary view that the preferred option was to buy the Fund back.

In the Capital Structure booklet released today, Fonterra notes that at around 6.7% of total shares on issue, the economic interest held by unit holders in the Fund comprises a meaningful component of the Co-operative. Fonterra says that it thinks it would be better to use its capital to support liquidity in the Fonterra Shareholders' Market as farmers transition to the new structure, rather than using it to buy back the Fund.

Fonterra also sees the Fund as continuing to provide a mechanism for people not involved in dairy farming to invest in the future of the Co-op, and as a reference for how outside investors value the shares. Fonterra notes that maintaining the position of the Fund within the NZX also supports research coverage of the Fund and of Fonterra's performance.

Fonterra notes that unit holders are an important part of the Co-op and undertakes to continue to consult with the manager of the Fund and consider unit holder interests.

## **Subcommittee's response**

The Subcommittee is disappointed by the revised proposals to the extent they relate to the Fund. In summary, based on the history of the Fund, and in the context of the objectives Fonterra has set out in the Capital Structure Review documents it has consulted with farmers on, members of the Subcommittee consider that-

1. The Fund has fulfilled the role Fonterra set it up for in 2012, which was to provide (as part of the overall Trading Among Farmer -**TAF**- arrangements) a stable capital base through removing the obligation on the Co-op to issue and redeem shares in response to increases and reductions in milk supply from farmers (Fonterra describes this as "redemption risk")
2. Maintaining farmer ownership and control of Fonterra is a key driver of the Capital Structure Review. Some 82% of respondents to Fonterra's online survey (asking farmers to list their top three priorities when it comes to Fonterra's capital structure) ranked ownership and control as their top priority. This reflects farmer discomfort with external investment
3. It seems unlikely that these concerns will be resolved by capping the Fund, particularly if, as we think needs to occur, steps are taken to make the Fund more attractive as an investment
4. Retaining the Fund, but removing features that support growth, liquidity, and relevance to investment markets, could put downward pressure on unit pricing
5. The changes required to meet the objectives set out in the Capital Structure Review provide a natural break point in the life of the Fund
6. Given the significant changes in circumstances and the lack of a compelling purpose for the Fund, it is equitable and appropriate that unit holders be given the opportunity to consider an offer to buy out the Fund at fair value

## **Subcommittee's recommended steps if the Fund is retained**

We recognise that Fonterra has competing demands on its capital, and that buying the Fund out at this time needs to be considered alongside other priorities. Over the course of 12 meetings the Subcommittee has therefore given considerable thought to how unit holders' interests can be protected if the Fund is retained. This work has included commissioning expert capital markets advice on steps that might be taken to mitigate some of the risks arising from a cap on the size of the Fund, and to make it more attractive to investors.

Members of the Subcommittee have engaged with Fonterra on these matters and conveyed their concerns, including by providing access to analysis from the Subcommittee's advisers. In summary:

### ***Clarity around purpose and commitment is critical***

1. The purpose in retaining the Fund needs to be clearly stated
2. Fonterra's commitment to the Fund and recognition of unit holders as a stakeholder group is critical

### ***The Fund rests on fundamentally different foundations under the proposed new structure***

1. The Fund's role as a key feature of the TAF arrangements largely disappears
2. The primary reason for its proposed retention appears to be that it comprises 6.7% of Fonterra's capital and now is not considered a good time to buy it out. However, acting as a capital base was never central to the strategy that underpins the Fund
3. Exchangeability of Fonterra shares and Fund units and the symmetry between share and unit price were key features of the original design of the Fund. These are undermined by the proposed changes

4. Statutory approval of the TAF arrangements when it was launched required a minimum Fund launch size of \$500m, which is close to \$100m more than the Fund's current market capitalisation

#### ***Proposed changes create liquidity and NZX50 Index exclusion risks***

1. Capping the size of the Fund and removing the ability for Fonterra shareholders to exchange shares for units is expected to have a dampening effect on liquidity, which has already drifted steadily lower over the five years
2. The reduced size of the Fund has caused it to become less relevant within the NZX50 Index
3. The Fund currently sits at number 46, having dropped from 25 in the NZX50 index when the Fund was listed in 2012
4. There is a risk that the Fund will drop out of the NZX50 Index in the near future
5. This could cause a flow of liquidity away from passive investors
6. Analyst research coverage of Fonterra is expected to drop if the Fund is no longer in the NZX50 Index

#### ***There are other uncertainties***

1. The impact of the proposed permanent decoupling of units in the Fund and Fonterra shares on the relative prices of each is unclear
2. In recent years ownership of the Fund has moved increasingly to farmers and ex-farmers, with an estimated 56% of units held by this group. It is unclear whether these investors will continue to support the Fund. The response of institutional and retail investors to a capped Fund is also uncertain

#### ***Investment returns have failed to meet expectations***

1. Some poor investment decisions and a lack of earnings have resulted in disappointing investment returns
2. Earnings per share have declined and Fonterra has been unable to maintain a consistent dividend policy
3. This has driven a decline in both the Fonterra share price and Fund unit price
4. Institutional and broker retail support for the Fund has fallen

#### ***The Capital Structure Review has caused further value loss to unit holders***

1. Based on recent trading on the NZX, the Fund's unit price has dropped by around 20% since details of the Capital Structure Review were announced in May. The Fonterra share price has fallen by around 32%
2. Fonterra has noted that share price is only one element of a farmer's equity. *"The goal is not to only maximise the share value. The goal is to maximise the whole enterprise value of the farm, which is land, cows and shares"* CFO Marc Rivers is quoted as telling *BusinessDesk* in June.
3. Investors in the Fund, other than those who are also farmers, derive value only from units. Many have suffered economic loss due from the contagion effect of the fall in Fonterra share price following the Capital Structure Review announcements. Most are not able to gain from increases in the value of other elements of the enterprise value of farms

### ***Benefits should arise from closer alignment between Fonterra shareholders and unit holders***

1. Under the proposed new share standard most farmers will hold more shares than they are required to hold to back their milk supply
2. This is expected to be positive as holders of these shares, like unit holders, will be wanting sustainable dividends and yield

### ***But important differences remain***

1. The Capital Structure Consultation booklet issued in May gives the results from an online survey Fonterra conducted earlier in the year. The survey asked farmers to prioritise up to three areas most important to them
2. The three top priorities were
  - Maintaining farmer ownership and control of the Co-op (82%)
  - Making sure Fonterra has a strong balance sheet that is resilient to changing milk supply and climate or economic shocks (65%)
  - Providing a good return on investment (53%)
3. External investors would be expected to attach a higher than 53% priority to a good return on investment
4. The Capital Structure Consultation booklet, and the updated booklet issued today, draw attention to another area where interests are not seen to be aligned. It notes that farmers will typically have higher cost of capital than unit holders, and this impacts on the price of units in the Fund (the concern being that unit holders will pay more for units than farmers, and that under the existing capital structure this feeds into the Fonterra share price)

### ***If it is retained, the Fund needs to be relevant and attractive to outside investors***

1. The Fund needs to be large enough to remain in the NZX50 Index and at a level that makes it relevant to investors and analysts and attractive as an investment
2. Increased size could be achieved through the Fund making a fresh issue of units while also being capped at a level that fully addresses concerns over ownership and control
3. Improved earnings performance, as Fonterra is forecasting, will help both size and attractiveness, but a fresh issue of units would show commitment while also mitigating most of the risks outlined
4. Reduced volatility in Fonterra's earnings would improve the reliability of dividends and support positioning the Fund as a yield investment

The Subcommittee has provided its views to Fonterra management. Members of the Subcommittee understand that Fonterra management agrees on some points but considers that increased clarity around strategy and forecast improved earnings performance, coupled with increased alignment between unit holders and holders of Fonterra shares, should address the downside concerns raised by the Subcommittee. On the benefits the Subcommittee and its advisers suggest could arise from a larger Fund size, Fonterra have confirmed that they will continue to consider this point.

It is important to reiterate that Fonterra is continuing to consult on the proposals. It has been clear in saying that it does not have a closed mind to the issues we have raised.

### **Importance of Fonterra's future earnings performance**

The single biggest factor that will impact the value of Fonterra shares and units in the Fund going forward is likely to be Fonterra's earnings and confidence that a sustainable dividend stream will be forthcoming.

The 2021 financial results, and the strategic aspirations outlined by Fonterra today, are encouraging. If the Fund is retained, when evaluating their investment unit holders will want to carefully consider the key targets Fonterra has outlined it is aiming to achieve by 2030. These include a 40-50% increase in operating profit from FY21, which would give Fonterra the ability to steadily increase dividends to around 40-45 cents per share by FY30, an uplift to 9-10% in return on capital and returning to shareholders and unit holders a portion of the proceeds of capital divestments.

### **Next steps in Fonterra Capital Structure Review process**

Fonterra's present intention is to consult further with farmer shareholders over the next few weeks with a view to finalising the Capital Structure Review proposals and putting them to a vote of farmers at the Co-operative's annual meeting in December.

No vote of unit holders in the Fund will be required if the recommendation to retain the Fund with a cap is approved. Unit holders will however have an opportunity to discuss the outcome of the Fonterra Capital Structure Review at the Fund annual meeting in December. Fonterra's Chairman, Peter McBride, and Chief Executive Miles Hurrell, together with other Fonterra executives, will be present to explain Fonterra's perspective and respond to questions.

If farmers vote in favour of the changes, an amendment to the Dairy Industry Restructuring Act 2001 (**DIRA**) is required to implement the cap. We have asked to be involved in consultation around the amendments to DIRA. The timing of the amendments will be dependent on Parliamentary timeframes.

### **Further work by Subcommittee**

The Subcommittee will continue to monitor the Capital Structure Review proposals and engage with Fonterra on matters relevant to unit holders. We understand the concerns many unit holders have expressed concerning the performance of the unit price. Within the limited scope of our governance role we will continue to act to protect unit holders' interests.

### **Important notice - this update does not constitute investment advice**

The purpose of this update is to convey the Subcommittee's views on Fonterra's Capital Structure proposals to the extent they are relevant to the Fund, and to outline the work undertaken and issues considered. It is not intended, and should not be used, as investment advice. There are several factors aside from the Capital Structure Review that investors will want to consider in evaluating the units in the Fund. These include Fonterra's 2021 financial results, outlook for 2022 and long-term strategic aspirations, all of which have been released today.

Yours faithfully

John Shewan  
Chair,  
Capital Review Subcommittee  
**FSF Management Company Limited**

*Members of the Subcommittee and independent directors of FSF Management Company Limited:  
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