FONTERRA
CO-OPERATIVE
COUNCIL

An update from your Council

June 2021

Capital Structure review

Feedback so far

We've pulled together a summary of what we're hearing, as many of you are keen to understand what your fellow Co-op members are thinking.

Around 4,000 have already attended a consultation meeting or joined a webinar. More meetings are scheduled throughout the regions, a lot of Co-op members are still digesting information, and many have yet to share or discuss their views and ideas.

Feedback so far reflects the diversity of our Co-op. There are some common themes, and there is also some divergence of view.

Here's our summary of key messages so far:

- **Members are pleased with the genuine consultation process that has been implemented**
- **Understanding is still developing**
  - We are in the early stages of consultation.
  - Many farmers are attending meetings seeking information and have not yet formed a view.
  - Most need more time to digest the options, work through some of the complexities and test their own beliefs.
  - There is appetite for smaller discussion groups to build understanding.
- **Most understand why we need to consider change**
  - Intergenerational succession is important.
  - There's recognition for the Board raising the issue now, which is an outcome of the work done to set threshold limits to protect farmer ownership and control when Trading Among Farmers (TAF) was introduced.
  - But there are mixed views on whether we need to address anything immediately.

This has led to common messages and questions on:

- **Share price impact and discovery**
  - Common questions are about:
    - loss of value and uncertainty of future share value (short and long term) due to the restricted market and potential changes to the supply / demand balance arising from the number of non-compulsory shares at a 1:4 share standard
    - the impact on dry shareholders (in particular those exiting the dairy industry), some of whom have already committed their share capital to their next venture but have not sold yet
    - the impact on those who have recently fully shared up.

- Shareholders want to understand more about share price discovery and transparency under the preferred option.

- **Milk supply**
  - It is generally well accepted and understood that milk supply is crucial to Co-op efficiency and performance.
  - Many are supportive of addressing this through flexibility.
  - Some of the supply challenges are not as well understood in regions where there is no competition or less environmental pressure.
  - Members are keen to:
    - see more data on forecast milk supply
    - understand the impacts on milk price and earnings if milk supply declines.
- **Performance**
  - Shareholders seek more confidence about performance and future earnings as the delivery of earnings in a farmer only market is seen as the key driver to share value.
- **1:4 Share Standard**
  - Common questions are:
    - Should flexibility be available to all or could a more targeted approach be beneficial to milk supply while protecting more of the current value in shares?
    - If there is too much flexibility, will shareholders trade a large number of shares shortly after the change to a 1:4 share standard, impacting share value?
    - Is it possible to predict future trading behaviours?
    - Who will be the buyers of shares in a 1:4 scenario?
    - Reflecting that farmers are a homogenous group of investors, in times of financial difficulty (e.g. drought) will many seek to share down?
- **Impact on loyal / shared up suppliers**
  - There appears to be a trade-off between protecting current value in shares and providing flexibility to ensure a sustainable milk supply.
  - But does the preferred option have the balance too tilted in favour of the enduring Co-op and newcomers to the Co-op, not long-term or fully shared-up suppliers?
- **Bank funding**
  - Questions are around how lenders might respond, including as a result of share price drop, and impact on interest rate margins.
- **Transition**
  - Effectively and fairly managing transition to any new capital structure is essential, and having confidence in and a good understanding of this will be critical to decision making.
- **Young farmers, sharemilkers, MyMilkers, contract milkers and managers**
  - Many in this group seek reduced capital constraints through more flexibility in our capital structure, and see the Board's preferred option as providing an achievable way of being part of the Co-op but also believe some skin in the game is important.
  - Others in this group feel the share standard should stay at 1:1 as reducing it departs from a true co-operative and may result in significant negative impacts in 20 years' time.
  - Some in this group:
    - see a need to have a strong share value that will reflect the success of the Co-op and reward the members that are loyal to it
    - would be prepared to 100% share-up over time if they felt it was a good investment based on current and future earnings.

Topics we believe warrant further discussion with members

- **Control and influence**
  - Good governance should control influence - is the soft influence of the Fund any worse or different than the soft influence of a large number of holders of dry shares?
  - How will the 1:4 share standard, and how could the 4x share-up limit, impact control – including what level of control could the largest 10% of farmers attain?
  - Further explanation on how selling down shares migrates voting power to fully shared-up members.
- **Voting**
  - Fonterra's Co-operative Principles state that voting should be in proportion to milk solids supplied, and under the Constitution this is limited to share-backed milk supply. If the compulsory shareholding requirement changes to 1:4 should votes align with milk supply, or a combination of milk supply and shareholding?
- **Alignment of ownership, control and supply**
  - The implications of alignment / misalignment of ownership (shareholding), control (voting) and milk supply.

Next steps for Council

- Attending the regional consultation meetings, and continuing to talk to members, to hear your feedback.
- Seeking independent advice on the possible liquidity and restricted market discounts arising from the preferred option.
- Reviewing other co-ops to inform discussion around the divergence of ownership, control and supply.
- Understanding the milk supply scenarios and testing the assumptions they are based on:
  - Scenarios have been presented – how realistic are they?
  - What are the wider NZ dairy industry milk supply forecasts? How do carbon and essential freshwater etc play into these and how might they drive milk flows down even lower?
  - What is the optimal milk volume for Fonterra?
- Better understanding:
  - how the preferred option would function (in terms of transition and as a permanent state) in reducing, stable and increasing milk supply scenarios
  - possible tensions in the future between the Co-op not wanting more milk (nationally or in certain areas) but members wanting more farmers in the Co-op who need to buy shares
  - taxation implications
  - possible DIRA implications, and the extent of DIRA change required, process and timeframes.
- Reporting back to you. Keep a look out for our further updates and emails.

Have your say

- Review the Capital Structure Consultation booklet online
- Read the Frequently Asked Questions
- Provide feedback here or email CS_Feedback@Fonterra.com

Our view on the Q3 Business Update

- There has been continued improvement in performance, with Q3 results in line with expectations.
- Our Co-op's scale, and ability to move milk to high value products and markets, continues to enable it to respond to ongoing global pandemic challenges.
- It is pleasing to see additional transparency, with EPS now being reported at Q3 for the first time.
- The Board has taken a measured approach when approving the 2021/22 season Advance Rate. The opening advance is 60% (rather than 65% as set out in the Advance Rate Board Guideline) of the midpoint ($8) of the forecast milk price range ($7.25 - $8.75 per kgMS). The Board advised it felt this was the prudent and responsible thing to do. It's relevant to note that the Advance Rate does not mean Fonterra is holding onto unpaid milk payments for free, as there is a charge in the Milk Price Manual calculation to compensate for this.
- Famers will notice greater simplicity in the Advance Rate schedule for next season with the removal of the capacity adjustment payment.

Questions put to Management

When Management presented the Q3 business update to Council our key areas of questioning were:

- The basis for narrowing this season's forecast milk price range resulting in a mid-point that is 5 cents lower.
- The seasonal profile of the milk supply curve relative to manufacturing costs.
- What's expected to impact earnings in the last quarter given NPAT at Q3 represents normalised earnings per share of 34 cents and full year normalised earnings are forecast to be towards the mid-point of the 25-35 cents range.
- Business performance and return on capital for key individual business units, including Australia and Chile.
- The final financial outcome of the Beingmate investment, given the sale of the remaining shares.

We have also requested medium term earnings expectations.

Independent analysis

Our independent financial analyst Northington Partners has summarised Q3 performance as follows:

1	**Q3 performance in line with half year trend**	- Normalised EBIT of $275m for 3Q21, which is $44m (19%) higher than the same quarter last year, driven by better Greater China performance (+$12m), lower operating expenses (+$38m) and greater other operating income (+$33m; mainly foreign exchange driven). - Year-to-date (9 months) normalised EBIT of $959m, being $144m (18%) greater than the previous year's equivalent of $815m.
2	**Milk Price impacts Ingredients business**	- Weaker performance was seen in the Ingredients business due to the higher Milk Price. Gross margins for the year-to-date declined to 9.4% from the 11.0% experienced in the same period last year.
3	**Consumer and Foodservice performance remains strong**	- Both Foodservice and Consumer margins were up across most geographies, with Greater China in particular benefiting from a strong economy that supported a shift of milk into higher value products.

4	**OPEX reflects movement to higher value products and markets**	- Year-to-date, operating expenses were reduced across Asia Pacific (-$18m) and AMENA (-$25m), in part due to the lower volumes reducing supply chain costs. Conversely, Greater China operating expenses were up by $27m reflecting expansion of the foodservice business.
5	**Transparency of Q3 EPS**	- Normalised earnings per share of 9 cents was recorded for the quarter, with 34 cents per share earned for the 9 months to date. This is 12 cents (57%) higher than the first 9 months of FY20, and the gain reflects in part the reduced debt load of Fonterra.
6	**Downward earnings pressure expected in Q4**	- The impact of the high Milk Price is expected to increase, placing pressure on margins and overall performance for the remaining quarter of the year. Management has maintained its forecast EPS to be towards the midpoint of the 25-35 cents range, indicating a possible small net loss in the fourth quarter as margins contract.
7	**Forecast Farmgate Milk Price announcements**	- Forecast Farmgate Milk Price for 2020/21 has narrowed to $7.45-$7.65 per kgMS, reflecting a midpoint of $7.55, which is $0.05 lower than the forecast midpoint at the interim result. A broad opening forecast range for 2021/22 of $7.25-$8.75 per kgMS.

Questions put to the Board

Below are three questions that we formally put to the Board this month, and its responses. We deliberately asked similar questions to those we put to the Board in Q1 and Q2:

Q: What key achievements were made during Q3 that demonstrate the implementation of Fonterra's strategy?

A: Q3 continues the story of the first half of the year. Fonterra has stayed on strategy and focused on what's in its control and this has come through in performance outcomes for the nine months ending 30 April 2021.

Operationally, we're continuing to experience some shipping delays but relative to global competitors they remain minor and product has continued to get to market, thanks to the partnership with Kotahi.

A few notable examples of implementation of strategy are:

- By shifting milk into higher value products, Greater China have improved their gross margin from 14.6% to 16.2% for the nine months ending 30 April. While gross margins improved across all three channels (Ingredients, Foodservice and Consumer) in Greater China, they were particularly strong in Foodservice at 28.6% year to date, up from 21.5%.
- Following a stable third quarter and with a focus on improving sales pricing (driving value of NZ milk), Asia Pacific's Consumer EBIT is up 29% to $156 million. AMENA's Consumer EBIT is up 58% to $82 million.
- Having worked on the transition to renewable energy for some time, it's been announced that Fonterra will get out of coal by 2037.
- Debt reduction over the last couple of years and lower interest rates have reduced the interest bill by $69 million for the nine months ending 30 April 2021.
- The sale of the shareholding in Beingmate has been completed, marking a full exit of investment in the company. Fonterra's sale of the two wholly owned China farming hubs in Ying and Yutian has also been completed. These divestments are allowing prioritisation of more resources around the Co-op's New Zealand milk which is key to the strategy.

Q: How well is Fonterra 'on-track' for meeting its current strategic objectives?

A: Under the three goals of Healthy People, Healthy Environment and Healthy Business, there are a series of targets to measure progress against the strategy. For a detailed summary of progress against these targets for this year please refer to the below table.

In relation to earnings, it is important to recognise that while year-to-date normalised earnings per share are 34 cents, it's expected earnings in the fourth quarter will come under further pressure due to high milk prices. Guidance is being provided that full year earnings are expected to be more towards the mid-point of the previously announced range of 25-35 cents per share.

Board Statement of Intentions

The Board Statement of Intentions sets out the Board's intentions for the performance and operations of Fonterra for FY21. In accordance with the Constitution of Fonterra, Fonterra is required to provide a regular overview to the Fonterra Co-operative Council of actual achievements, compared with the targets set by the Board. The table below provides an update of Fonterra's performance against these targets as at 30 April 2021.

		FY21	
	FY20	Q3 Actual	Full Year Target
Healthy People			
Total recordable injury frequency rate (TRIFR) per million work hours[1]	5.8	5.1	5.0
Female representation in senior leadership[2]	29%	30.9%	35%
Employee engagement	4.07	4.09	≥4.11 (Top Quartile)
Farmer sentiment (Net Promoter Score for Fonterra in New Zealand)	33	42	10[4]
Healthy Environment			
Number of farms with Farm Environment Plans (New Zealand)	34%	47%	45%
Reduction in water used at sites in water-constrained regions versus FY18	(3.1)%	(2.8)%[5]	(10)%
Reduction in greenhouse gas emissions from manufacturing versus FY15	(5.7)%	(10.5)%[5]	(10)%[6]
Solid waste to landfill (kilotonnes) below FY20	15.9	9.0[5]	13.1
Healthy Business			
Fonterra % kgMS of New Zealand milk collected for the season ended 31 May	80%	NA[7]	80%
New Zealand Farmgate Milk Price (per kgMS)	$7.14	$7.45-$7.65[8]	$5.90-$6.90[8]
Return on capital	6.7%	On track	6% to 7%
Debt/EBITDA	3.4x	On track	3.0-3.5x
Gearing Ratio	41.4%	On track	36 to 40%
Normalised earnings per share	24c	25c to 35c	20c to 35c

1. *Part of zero harm philosophy which also includes target 0 serious harm/ 0 fatalities.*
2. *Senior leadership defined as Band 14+.*
3. *Employee engagement is measured through a company-wide survey.*
4. *The Net Promoter Score for Fonterra was (17) when the target was set.*
5. *The Q3 position has been calculated utilising actual data where available or estimates.*
6. *Assumes Te Awamutu conversion to wood pellet is completed for full use in FY21.*
7. *Only available on an annual basis.*
8. *Based on latest publicly announced Forecast Farmgate Milk Price.*

Q: What new and/or emerging challenges is Fonterra facing, in relation to its strategic objectives, and how is it responding?

A: For the last quarter of FY21, the immediate challenge for the business relates to further pressure on margins. While overall, stronger gross margins have been seen so far this year, they've narrowed in the third quarter as the increasing raw milk prices have flowed through to input costs and, in addition, the impact of pricing lags on sales contracts with major customers has delayed the ability to pass through the increase in input costs.

As a result, increased pressure on margins is forecast in the fourth quarter. This is compounded by the normal seasonal profile of the business, where we have ongoing fixed costs but lower volumes of milk are being processed and sold. All of this means the fourth quarter will be challenging from an earnings perspective and we expect the margin pressure to continue into the first quarter of the 2022 financial year. Fonterra is responding through activities to generate further demand for its products. It is also managing costs carefully, through the financial discipline embedded in the business.

As mentioned above, we're experiencing some shipping delays due to the congestion across the global supply chain and we are continuing to work with Kotahi to get our product to market and minimise the impact of increased shipping costs.

For the Co-op's 2021/22 forecast Farmgate Milk Price, there are number of risks. These are also relevant to the Co-op more generally and include:

- COVID 19, which is far from over;
- Impacts of governments winding back their economic stimulus packages;
- Foreign exchange volatility;
- Changes in the supply and demand patterns that can enter dairy markets when prices are high; and
- Potential impacts of any geopolitical issues around the world.

These broader challenges are being responded to by staying on strategy and focusing on what's within our control. This includes being close to customers and understanding in advance their consumption trends and local operating environments, as well as minimising risk by continuing to sell milk into a diversified portfolio of consumption categories, in multiple regions/markets around the world.

Reporting to the Board

In our May report to the Board we advised the following sentiment and feedback from Co-op members:

- Sentiment about the direction and performance of the Co-op continues to be largely positive, and there is general optimism about the dairy industry.
- Research conducted in April on Council's behalf by UMR Research showed that of the 1000 Co-op members surveyed:
  - most are confident about their Co-operative and the New Zealand dairy industry;
  - over half are likely to invest in their business over the next few years;
  - four out of five members were more comfortable with Fonterra's overall direction compared to two - three years ago;
  - around half say they understand Fonterra's current strategy; and
  - in terms of support for the strategy, over two-thirds believe that Fonterra has the balance right between consolidation and growth.

- The topic most frequently raised with Councillors (excluding the capital structure review) over the last quarter has been Co-operative Difference. Many members are positive, or at least understand why the framework has been introduced, but farmers are still developing their understanding of how it works.

We have asked the Board to provide more information to members on:

- medium term earnings expectations (noting the 3 and 5-year guidance given with the FY19 results);
- how Management will measure the premium that's created for our New Zealand milk;
- the return on capital being derived from key business units such as Fonterra Brands NZ, Australia and Chile;
- global supply and demand outlooks; and
- milk price trends in terms of prices received by NZ farmers compared to farmers in key overseas markets.

Key activities

Since our last update we have:

- Represented your views to the Board at its May meeting. *(See above.)*
- Been briefed on the Capital Structure proposal by management and the Board, attended all the Director led consultation meetings, and analysed and discussed the feedback we have heard so far. *(See above.)*
- Met with Miles Hurrell (CEO) and Marc Rivers (CFO) to receive and discuss the Q3 business update, and discussed that update with our independent financial analyst Northington Partners. *(See above.)*
- Made a submission on the Climate Change Commission's draft recommendations. You can read our submission here.
- Held farmer meetings in most Wards. The purpose of these meetings is to create regular opportunities to connect with members and to capture your views and feedback.
- Worked with members of the Board to review the 2016 Governance and Representation changes, as modified following the review of the Director election process in 2018 and the review of Council in 2020. The conclusions and recommendations from this year's review will be shared with you shortly, for your feedback.
- Completed research to better understand members' views and expectations, and started drafting the first Letter of Members' Expectations to be delivered to the Board. We expect to share a draft of that Letter with you shortly, for your feedback.

The full Council met in May while in Auckland for the MyConnect conference. Key agenda items were:

- The Board's capital structure options, including presentations from two external advisers to the Board on the expected outcomes of farmer-only trading (in terms of the restricted market discount and risks of ownership concentration and voting), and the benefits of retaining supply.
- The results of the research undertaken to inform the Letter of Members' Expectations to the Board.
- A presentation from Management on the 2021 Director election skills matrix

Other Council activities

- Council Chairman James Barron has spoken regularly with Fonterra Chairman Peter McBride. James conveys farmer feedback and Peter and James inform each other on the progress of Council and Board workstreams.
- In April, around 75 Co-op members attended the Understanding Your Co-operative Programme (UYCP), hosted by four Councillors. The June programme is full, with over 110 registered to attend, but there are still places available for the November/December event.
- Four Councillors represented farmer views and perspectives on matters relating to New Zealand milk supply at the May meeting of the Board's Co-operative Relations Committee.

Tell us what you think

Did you find this Update useful?

Please [click here to answer four short questions] to help us make it more relevant to you.