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CRUNCH TIME

"I've just seen many cooperatives going down the drain when investor interests start prevailing over producer interests."

– Dutch co-op expert Onno van Bekkum

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Share valuation the real issue – Dutch expert

ANDREW SWALLOW

FONTERRA HAS a serious problem but, contrary to the board's claims, it is not redemption, says a Netherlands-based cooperatives expert.

"Share valuation is really the heart of the problem," says Onno van Bekkum, chief executive of Coop Champions and a lecturer on cooperative businesses at Nyenrode Business University.

Van Bekkum has produced a report for a group of Fonterra shareholders concerned at TAF's implications for the cooperative's future, and supplied an exclusive preview article to *Dairy News.*

"There has been a lot of good thinking gone into this [TAF] proposal. But I fear with this impressive level of technical detail farmers might lose sight over the bigger picture," he warns.

He doubts share trading will contribute to a stable cooperative, and says he can't think of any example where such a system has worked to the satisfaction of farmers.

"I've just seen many cooperatives going down the drain when investor interests start prevailing over producer interests. That's what TAF does: it deliberately creates a separate cluster of investor interests – both internal and external. You don't want that in a cooperative. You want to keep a clear focus on producer interests."

While he has concerns at what is effectively a scheme that will encourage some to cash in their shares, it would be understandable if it was a means to raise capital, he adds.

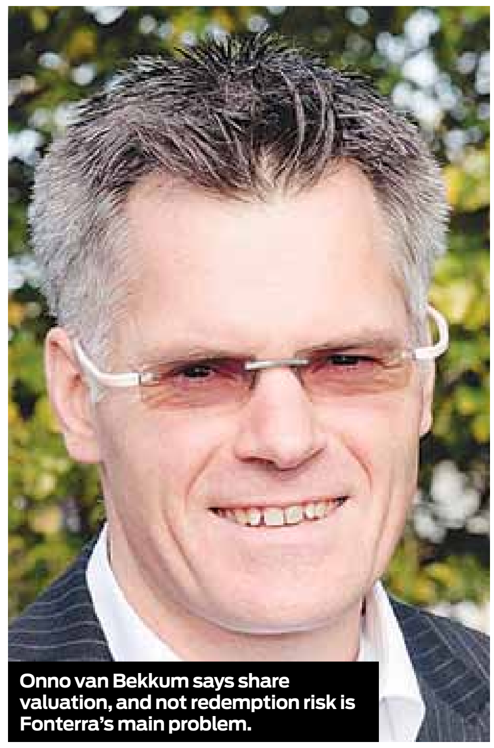
"Then at least you would build up something."

As it is, the trading of dividend-bearing units linked to shares will simply drain up to 20% of dividends from the cooperative.

"If you decide to trade, why not start trading internally?"

He also doubts Fonterra will be able to limit the fund size, as it suggests.

"I don't think farmers would vote in favour of TAF thinking they won't be using the fund. There will always be moments when people are in need of cash."



Onno van Bekkum says share valuation, and not redemption risk is Fonterra's main problem.

He notes the blueprint itself mentions "avoiding a flood of shares into the fund after launch".

"I fear it might not be long until the constitutional limit of 20% may be reached, with or without shocks created by droughts, diseases, financial crises, etc. And then what?"

The board has several options, as proposed in the risk management policy.

"Firstly, buying back units, which means you're basically back on a track similar to redeeming shares. So how much do you gain from TAF?

"Secondly, introducing dividend reinvestment. Great, but you don't need TAF for that!

"Thirdly, reducing the transfer limit, which requires members to buy back a portion of their shares: I'm not sure if that would really work in practice.

"Fourthly, issuing shares, to farmers presumably. Does that mean raising the limit on dry shares? Doesn't that mean we're further down the sliding slope then?

"Fifthly, altering the constitution to allow more than 20% in the fund. Is that what a 'preferred option' – to be recommended at a 'special meeting' for shareholders – could also be about? That, again, is risky."

Van Bekkum says he would solve Fonterra's valuation problem without introducing dry shares.

"The restricted share value was a step in the right direction."

End-of-season transaction, a rolling three season-average production/share requirement, and three years to buy in/out all make sense, as does dividend reinvestment.

The fact that reducing share value to the restricted figure of $4.52/share from its $6.79 peak passed without uproar from farmers is a positive sign that shareholders, in general, are not overly focused on share value, he says.

"As the leadership has begun to see, the basis of any strong capital base is retained earnings. I think these are sufficient ingredients for a robust capital structure. I would be inclined to think you might not really need TAF."

As for redemption risk, TAF effectively passes it to farmers.

"I think it's not fair simply to pass that burden on to farmers' shoulders. It's not particularly cooperative. It's amazing that farmers just accept that without discussion."

COMPLEX DOCUMENTS

THE COMPLEXITY of the documentation supplied by Fonterra on TAF is noted by van Bekkum.

"Your New Zealand farmers must be highly educated people to read this language of lawyers and accountants."

TAF has never been about raising new capital

COMMENT
JONATHAN MASON

FAR FROM adding risk, Fonterra's proposal to adopt TAF (trading among farmers) is about reducing risk and protecting the cooperative nature of the country's leading exporter.

A point missed by many opponents of TAF is that the current way Fonterra manages redemption risk, by funding it through its own balance sheet, is by no means a low risk strategy.

As the co-op grows, and milk supply (backed by shares) grows, so too does redemption risk. And by redemption risk I mean the obligation on the cooperative to pay out cash to any farmer leaving the co-op or reducing his or her milk supply and, therefore, number of shares. Fonterra currently ties up about $1 billion of room on its balance sheet to cover this requirement.

TAF simply facilitates what it says – it allows farmers to trade shares, so that they can buy more shares to grow milk supply or sell shares to reduce supply or even exit the co-op if they choose. TAF isn't and never has been about raising new capital. It was conceived and remains focused on providing Fonterra farmer shareholders with the stability of permanent capital.

Under TAF, redemption risk is replaced by a fully transparent, tradeable market that delivers a well-discovered price for farmers' shares. Only dairy farmers supplying Fonterra (and the Fonterra farmer custodian) can own shares.

Using a market to let farmers buy and sell shares is a better way of farmers 'sharing up or sharing down', as dairy folk call it, than by Fonterra having to come up with the cash to buy out farmers.

Establishing a fund whereby non-farmers as well as farmers can buy units that get the benefit of the dividends and capital movement of shares is only required to ensure that the market in which farmers trade their shares delivers what economists call a 'well-discovered price'.

That's all the fund is for; it doesn't bring in new capital and unit holders obtain no voting rights or influence over the shares themselves. Voting rights in the co-op are based on milk production, and that remains with farmers at all times. TAF is anchored upon the core cooperative principle that share ownership must be in proportion to milk supply.

Of course no system is without risk. So what has Fonterra's due diligence process identified as the biggest risk of TAF? The answer is managing the size of the fund that helps enable liquidity and price discovery for the shareholder market for shares.

That's why TAF includes a fund risk management policy with ongoing review of the size of the fund, and policies and procedures that would be activated should the actual size of the fund ever exceed 12% of total capital in the cooperative.

The objective is for the fund to be 7-12% of total capital – just enough to make the farmer shareholders' market work well, but no bigger than is necessary for an efficient market in farmer shares.

During the board's due diligence on TAF, Fonterra modelled a number of hypothetical scenarios in which the cooperative was hit by significant financial shock – for example, reduced production through drought or mass supplier exodus from the co-op.

This showed that managing these financial shocks under TAF was less risky than under the current system. The high-powered independent advisors appointed by the board's due diligence committee scrutinised this modelling and found that a properly managed TAF system – including a fund risk management policy – to be less onerous from a risk management perspective than managing redemption risk under the status quo.

Far from being a 'crossing of the Rubicon' or a risky leap of faith, a move to TAF is just the latest step in a series of well-thought-through, always well-debated steps the dairy industry has carefully taken on its long hikoi to global success.

Since reforming their share structure in 2009, to voting for TAF in 2010 to the important decisions on safeguards and constitutional parameters to be taken on June 25, 2012, dairy farmers know their business involves a careful balancing of risk. They have always carefully weighed the options and taken prudent steps.

In 50 years from now, perhaps no step in that long and fruitful co-operative journey will have been as important as TAF which removes redemption risk – one of the biggest risks and challenges for any co-operative – from Fonterra's balance sheet and replaces it with a robust market for shareholders.

That Fonterra has created a shareholder market unique in the world for its effectiveness but also its robust protections of 100% farmer control and ownership is just another – albeit complex – example of the Kiwi dairy industry's global leadership in innovation and a commitment to forge its own destiny.

• *Jonathan Mason is Fonterra's chief financial officer.*

Complex voting pack is bad business

ANDREW SWALLOW

NEVER MIND the detail, it's the whole cooperative ethos that is at stake in this month's TAF (trading among farmers) vote, says one of the shareholders who instigated the second ballot.

"My first reaction was one of disbelief," South Canterbury farmer Leonie Guiney told *Dairy News* after receiving her voting pack. "It's so complex. Complexity isn't clever. It's bad business and bad governance."

Nothing in the 64-page blueprint, or 24-page due diligence report, allays her view that TAF will prove to be the thin end of a wedge that divides the cooperative.

"If this goes ahead there'll be the opportunity to 'game' shares, and a shift away from the principles of collective risk, collective reward, and collective responsibility that our cooperative was built on.

"There'll be opportunities for individuals to gain short term from the equity that has gone into Fonterra over generations."

Traders in units will drive volatility in share price, and farmers holding dry shares will become more focussed on dividend and return on their investment, than milk price, she warns.

"Farmers will have conflicting desires from Fonterra."

Guiney says the board's attempts to minimise the risk of gaming, for instance reducing the size of the fund, prove they've woken up to the risk.

"They can see the potential for gaming and the potential for this to demutualise the co-op, and what for? All for a $500m fund to stop redemption risk. If anything, this has the potential to increase redemption risk."

"It's so complex. Complexity isn't clever. It's bad business and bad governance."

Rhetoric that the board is looking for a stronger mandate than the 50.1% minimum for the TAF vote to pass do not appease. Guiney says chairman Henry van der Heyden should front with a threshold figure without delay. "He should define it before the vote, not reserve the right to define it afterwards."

Similarly, repeated assurances about 100% ownership and control don't wash as investors in units will, unless the law is changed, have rights which mean they can exert some control in the cooperative.

Guiney notes Fonterra's submission to the primary production parliamentary select committee considering the DIRA amendment bill seeks an exemption to those rights.

As for 100% ownership, those guarantees ring hollow too as beneficial rights (i.e. dividends) passing to unit holders effectively confer ownership to those unit holders.

"We are having the wool pulled over our eyes on the 100% ownership issue. It's why Simon Couper stood down, yet that was dismissed as just a speed bump by the board."

Given there are already mechanisms to reduce redemption risk the million dollar question remains: what is the real reason the board is so keen to implement TAF? she asks.

"The booklet on my table fails to explain to me just what is wrong with our fantastic cooperative. It tells me only how many experts we have employed to mitigate the risks this fund sets up. I can only think [the reason for TAF] is because it will give management the opportunity to leverage the balance sheet more aggressively."


Leonie Guiney

Warning from the past

A DAIRY farmer who's served as a director of a cooperative dairy company for 48 years says he's concerned about Fonterra's TAF proposal.

John O'Connor, Wesport, says he's worried at the way the proposal is worded so that outside and foreign investors will wield power and may not provide the financial stability that Fonterra claims will happen if TAF goes ahead.

He says Fonterra is concerned about redemption risk and money flowing out of the organisation when farmers leave the industry.

But O'Connor says the situation may be no different with outside investors. "Even if investors don't have voting power they could influence the decisions. Money is powerful and they could influence decisions by threatening to or actually taking their money out. Fonterra has been worried about the inflow and outflow of money. The money flowing out from outside investors could be just as dangerous."

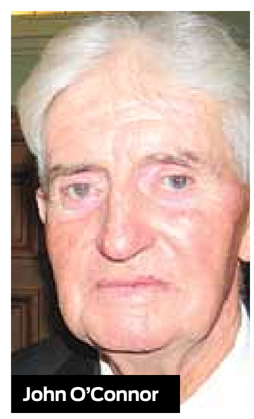
O'Connor says he can't see why Fonterra can't raise capital itself.

He also points to a similar situation in 1973, when the international food giant Kraft attempted to buy cheese factories in Taranaki.

"The chairman of the dairy board at the time, Laurie Friis, was in favour of Kraft investing in New Zealand but not all board members were in favour.

"I was chairman of Federated Farmers Dairy section at the time and we strongly opposed Kraft's move into New Zealand. In the end we won and the dairy board went on to raise enough capital to expand without the assistance of a multinational company."

O'Connor says he's great believer in the cooperative movement and says anything that dilutes the strength of that movement is not good. Before farmers vote on TAF they should be satisfied that it will in no way compromise Fonterra's cooperative status and its total control by farmers, he argues.


John O'Connor

Looking for 'clear signal'

SUDESH KISSUN

THE NEW Fonterra Shareholders Council chairman Ian Brown has his work cut out over the next two weeks.

Fonterra farmers are mulling TAF (trading among farmers) and casting their votes and Brown is looking for "a clear signal" to launch the scheme.

Fonterra's board unanimously backs TAF and at least 30 of the 35 councillors support it.

While Brown isn't willing to predict the June 25 vote, he acknowledges whatever the outcome unity among the 10,500 shareholders is paramount.

"If the vote is not definitive, then the unity among shareholders will be our number one priority," Brown told *Dairy News*.

"Everything else drops. We need a clear sense of direction from shareholders. The board is unanimous, the council has given a clear verdict and now it's up to shareholders."

TAF is unpopular with some Fonterra shareholders. Brown says influence of outside investors through the Fonterra Shareholders Fund and the farmgate milk price are main concerns. He believes under TAF there are stringent checks and balances in place to ensure 100% farmer ownership and control. The council will have two representatives on the five-member milk price panel, a requirement that will be enshrined in the co-op's constitution on June 25. The council will also receive regular reports from the Fonterra board on the fund size.

The council engaged independent advisors for separate due diligence. Brown says many meetings were held with the Fonterra board to ensure farmer concerns were addressed.

"If anything, we have strengthened farmer ownership and control with TAF."

The TAF vote is not the end, he adds. "I'm confident we've climbed the hill and ownership and control has been locked down.

"But the fund and the fund size is the risk and we cannot let our guard down. The council will play a monitoring role to keep it within the parameters of policy.

Brown is "okay" with some councillors not agreeing with TAF. "We will never get 100% and I'm not using that as an excuse. I have no fear we have not done our job well. With a large shareholder base we get extreme views and that's part of the healthy debate."

But Brown believes the council has listened to the dissenting voices and responded to them.

Voting papers and TAF documents were sent to shareholders two weeks ago. Fonterra directors and councillors last week met shareholders throughout the country to discuss the plan.

Brown wants farmers to do their homework before casting their vote. "Get an understanding of TAF, get hold of your local councillors, talk to your neighbouring farmers, hold shed meetings."


New Fonterra Shareholders Council chairman Ian Brown.

ABOUT IAN BROWN

IAN BROWN milks 300 cows at Tokoroa, South Waikato.

He joined the council seven years ago and served as deputy chairman for 22 months. He took over last month as chairman when Simon Couper resigned over TAF.

DIRA Bill passes hurdle

ANDREW SWALLOW

PARLIAMENT'S PRIMARY Production select committee, last week, recommended the Dairy Industry Restructuring Amendment Bill, including legislation enabling TAF, be passed with changes.

The seven-man committee's recommendations include tweaking Clause 77a so if TAF doesn't proceed, an unrestricted fair value cooperative share price can be implemented.

Creating a back-up option to TAF that involved regulating share price might be unfair for shareholders to consider before voting on the scheme, it reasons.

Other recommendations include measures to prevent Fonterra limiting fund liquidity and fund liability, ensure freedom of entry and exit from the cooperative in the event of TAF being wound up, and preventing legislation putting Fonterra efficiency ahead of farmgate milk price contestability.

However, the committee's report contains a stinging minority view from the Labour and Green Party members (Shane Jones, Damian O'Connor and Steffan Browning) that claims "short timelines" and limited advice on TAF "has resulted in a bill that contains risks for the dairy industry and Fonterra."

"Independent advice... identified risks that have not been properly considered. Advice from officials with limited knowledge of co-operative company principles and objectives left many concerns raised by submitters unanswered," the minority report warns.

It questions the aim of "fair-value" share price discovery (as TAF would do) given the co-operative status of Fonterra and clear desire of farmers to have it remain a co-operative.

"Many submitters requested the removal of section 77A and, while improvements have been made, we feel the imposition of such a valuation system on a co-operative is untested.

"This legislation implements fundamental change to Fonterra, a co-operative that is the largest company in the most significant export sector in New Zealand.

Any reduction in control or ownership has risks for farmers and the country.

"We are concerned that an immediate and unavoidable consequence of the establishment of the TAF scheme will be the loss of an unknown and uncapped proportion of the dividend stream generated by Fonterra's profits, currently retained by New Zealand farmer shareholders, to overseas investors.

'Redemption risk will increase'

ANDREW SWALLOW

RATHER THAN reducing redemption risk, as Fonterra's board claims, TAF (trading among farmers) could increase it, says former Federated Farmers Dairy chairman Lachlan McKenzie.

McKenzie told *Dairy News* last week he doesn't think the blueprint, or any of the other documentation circulated to shareholders, adequately explains the purpose of Fonterra as a farmer-owned cooperative, and how TAF will help that.

"There is all this talk of redemption risk, but redemption risk has many facets. The biggest redemption risk to Fonterra is lack of milk supply and TAF has the potential to see more milk supply redemption than under the current restricted share value capital structure."

TAF will leave the board with limited, if any, control of share value, which could rapidly rise providing a strong incentive for share redemption, he maintains.

For example, if, as forecast, profit per share is 50c this year, then at a 15:1 price-to-earnings ratio, that justifies a $7.50 share value.

"It's quite conceivable that in a very short period of time we could have a $10 or $12 share. That would be a significant incentive for some to cash up and go somewhere else."

McKenzie also thinks Fonterra "doesn't have a dog show" of controlling the size of the fund.

"There will be enormous pressure from farmers and outside investors to increase it.

It'll be a blue chip investment," says McKenzie.

Farmers don't really need TAF

Onno van Bekkum*

Does Fonterra have a problem?

Interesting question. Yes, I think Fonterra has a serious problem. They call it the redemption problem, but I think that's not true. I think share valuation is really the heart of the problem.

I have gone back to the annual reports since formation: It appears farmers contributed the phenomenal amount of $7.2 billion. Whoever said cooperatives can't raise member capital? During the same period, $5.9bn was redeemed. The net contribution was $1.3bn. Had shares value been left unchanged at $3, the net contribution would have been $1.0bn. So, Fonterra 'earned' 300m due to share value increase. That's very little!

Now the problem comes: the outstanding redemption claim back in 2002, based on a $3 share amounted to $3.3bn. That's the amount the co-op would have had to pay if all members left. By 2008, with a share price of $6.79 that amount had increased to $8bn. Raising $300m, Fonterra built up an outstanding claim on its equity equal to $4.7bn. Unbelievable. That's the heart of the problem: this was the millstone around Fonterra's neck! This wasn't ever contributed in cash. It was just the outcome of the valuation process. With nothing much in the books to substantiate this increase. Valuation was based on the wrong set of parameters, that's what I think.

Interestingly, during the past two years Fonterra generated more profits than the previous eight years together. During these two years the mid-point came up only 11 cents. With the remarkable move of suddenly declaring Fonterra shares were 'members only' 25% could be slashed off the share price, which was subsequently frozen at $4.52. And the cooperative started a retention policy. Within two years $925m equity was raised. Permanent capital. Fonterra doesn't have a capital problem! It has a man-made problem that is called "share valuation".

If the Board ciphers the potential cost to cover the redemption problem possibly as much as $1bn - how insurmountable could this be? In the long history of Fonterra yet to come, it's just a two years' retention. Does this $1bn justify all the fuss?

Let's go back to the merger: the government allowed the Dairy Board to merge with the two co-ops. But it wanted to give this value to farmers, not to Fonterra. So that if farmers decided to leave, they would take out this value and invest it in their next dairy venture. That's why shares were priced at fair value, wasn't it? Now, a decade later: how much of Fonterra's current value changes may still be ascribed to the Dairy Board? Very difficult to say, right?

The redemption problem is not the washing in and out a couple of hundred million dollars. With a 'Dutch thumb', that leak is stopped quite easily. Sure it's very nice for Fonterra to be relieved from an outstanding redemption claim of billions of dollars. That's a very different piece of cake! But I think it's not fair simply to pass that burden on to farmers' shoulders. It's not particularly cooperative. Amazing farmers just accepted that without discussion.

I'm impressed, by the way, that farmers didn't clamor when the share price came down from $6.79 to $4.52. That was a lot of money that just evaporated. It gives me confidence, though, that the majority of farmers would seem to be prepared to make a sacrifice and remodel a deficient share structure differently.

You appear not to be a strong proponent of TAF. Why is that?

I find it a very complex solution and I'm not entirely sure what problem it really solves. And if that problem couldn't be solved better in a different way. I see quite a few irrelevant ‘selling points’ such as “being in the driver’s seat”, being “easier to use” etc. And I get quite tired every time I read Fonterra’s documents, ever since the merger, really. Your New Zealand farmers must be highly educated people to read this language of lawyers and accountants.

There has been a lot of really good thinking gone into this proposal. But I fear with this impressive level of technical detail, farmers might lose sight over the bigger picture. You really have to think along the lines of the specialists in order to be able to understand it. And hence let go of your own thinking on the way. Former Campina chairman, Jan Loonen, once told me many years ago: “If my CEO has difficulties explaining things to me in a language that I can understand, I am quite straight to him and tell him that he’s the one who has a problem then, not me.” He was my type of guy.

I see how the current blueprint removes a number of concerns about e.g. the ownership of the legal title. The Fund size has been lowered from 25 to 20%, and a number of additional controls and protection mechanisms are introduced. Still I wonder: is this what farmers really asked for?

This capital structure debate has been dragging on since 2006 now and I get the impression the designers of the scheme are very persistent in their views. As if share trading is the panacea to all of Fonterra’s problems and that the public must play a role in this. I doubt whether share trading contributes to stable cooperative solutions. Can’t really think of any example that has truly worked to the satisfaction of farmers. I’ve just seen many cooperatives going down the drain when investor interests started prevailing over producer interests. That’s what TAF does: it deliberately creates a separate cluster of investor interests, both internal and external. You don’t want that in a cooperative. You want to keep a clear focus on producer interests.

What is it about TAF that concerns you specifically?
I have difficulties understanding the cooperative logic of TAF. For example, for some reason the minimum size of the Shareholders Fund must be $500m. Why? I really don’t know. It seems to be some magical number that someone (government? why?) started talking about and then people kept repeating. Or was it “hard math”?

Okay, so then they want to encourage farmers during the book-building process to actually sell the economic rights of their shares. That’s unparalleled! I have never seen a cooperative that asked its members to cash their shares. I would have understood if they had used the opportunity to actually raise some fresh capital. Then at least you build up something. I would have had strong concerns, but at least I would have understood. Now it seems they’re just breaking down.

I don’t like trading of delinked shares with performance-based dividends at all. But if you decide to trade, why not start trading internally? Why begin creating a minimum $500m Fund? And drain up to 20% of your dividends? And introduce something that may be cumbersome to remove after two years, and definitely very costly?

Then I have doubts about the management of the Fund size. I don’t think farmers would vote in favor of TAF thinking thinking they won’t be using the Fund. There will always be moments when people are in need of cash. And there will always be periods when other farmers are short of cash. Actually, the Blueprint itself mentions “avoiding a flood of shares into the Fund after launch” as an issue of concern.

I realize that back in 2006, Dairy Equity only met with lukewarm response from farmers. And while TAF is very similar, this is very different as well. TAF is being promoted by the cooperative itself. This is Board policy. The Board will expect farmers to sell economic rights and will actively promote it. Now you buy shares because you must; under TAF you’ll keep the 66% of shares that you must and look at the other 33% from an investor perspective. That creates a very different sort of dynamics. I fear it might not be long until the Constitutional limit of 20% may be reached, with or without shocks created by droughts, diseases, financial crises etc.

And then what? According to the proposed risk management policy, the Board has several options, once it has halted sales of economic rights to the Fund: Firstly, buying back units, which means you're basically back on a track similar to redeeming shares. So how much do you really gain from TAF? Secondly, introducing a dividend reinvestment plan. Great, but you didn't need TAF for that. Thirdly, reducing the transfer limit, which requires members to buy back a portion of their shares. Not sure if that would really work in practice. Fourthly, issuing shares, to farmers presumably. Does that mean raising the limit on dry shares? Doesn't that mean we're further down on the sliding slope then? Or perhaps, fifthly, altering the Constitution to allow more than 20% in the Fund. Is that what a "preferred option" to be recommended "Special meeting" for shareholders could also be about? That, again, is risky.

How would you have solved Fonterra's problem?

I would have stopped before introducing dry shares. The restricted share value was a step in the right direction. I thought the end of season share transactions arrangement made a lot of sense. I liked the share standard with a rolling three seasons average and the three years buying in and selling down periods. Perhaps you might wish to consider a valve to ensure redemptions don't exceed share issues during such periods. A dividend reinvestment program, as envisaged under TAF, is excellent. On top of that you might want to consider a share off-take program based on total supply, rather than only on supply growth as it currently is. And perhaps not just New Zealand milk, but -why not- Australian milk as well? With perhaps a tradable, fixed-return permanent bond to attract voluntary investments from members who can afford. But, as the leadership has begun to see, the basis of any strong capital base are retained earnings. I think these are sufficient ingredients for a robust capital structure. I would be inclined to think you might not really need TAF.

* Dr. Onno van Bekkum is Cooperative Strategist and CEO of "CO-OP Champions" in the Netherlands (www.coopchampions.com). He lectures cooperative case studies in the Food & Finance Executive MBA of Nyenrode Business University. He has been commissioned by New Zealand dairy farmers to write a report reviewing TAF.