Reflections on 10 years as Chair of the Fonterra Shareholders' Fund
14 November 2022

1. The Shareholders' Fund was formed by Fonterra almost exactly 10 years ago this month as a solution to a major problem with the Co-operative's capital structure. That problem was a capital base at risk due to the obligation on Fonterra to redeem (ie pay back) farmers for their shares when they reduced supply or exited the Co-op.

2. The Trading Among Farmers structure brought that to a halt by enabling farmers to trade shares among themselves and convert dry shares into units that could be traded on the highly liquid unit market through the NZX main board, that liquidity being provided mainly by external investors.

3. Looking at that *primary objective*, the Shareholders' Fund has been highly successful- it scores 10 out of 10. Fonterra has achieved its objective. The Fund and the associated Trading Among Farmers arrangements created a stable capital base.

4. But has the Fund delivered for unit holders? For the large part, no. As the inaugural chair of the Fund, I want to apologise for the fact that, for most unit holders, the investment returns from the Fund over the decade since its formation have been dismal. I find that outcome both unacceptable and deeply disappointing, both as chair and as a unit holder.

5. The unit price on issue in 2012 was $5.50. Today it is about $3.00, a drop of 45%. Dividend payments have been modest, and in some years non-existent. Over the same 10-year period the NZX 50 index grew by 175%.

6. Commenting on the share price, Fonterra says 'it's fair to say that Fonterra's track record on paying a respectable return on capital over time has not met expectations.' In the context of a 45% loss over a decade where the market has delivered a 175% gain, I consider that to be an understatement of truly remarkable proportions.

7. In reflecting on the past 10 years, I want to speak briefly to 3 questions I am often asked:

   - Why has the unit price performed so badly?
   - Won't milk price will always be set in a way that favours farmers over shareholders?
   - Do unit holders have any reason to be positive?

What has contributed to the fall in unit price?

8. The way I see it, aside from general market movements there are 4 buckets of issues that have been key drivers of the Fund's unit price over the past decade:

   (a) Fonterra's core operating performance, which has been disappointing
   (b) Some extraordinary left field influences- in particular the 2013 botulism scare and associated litigation
   (c) Some major strategic investment decisions that failed to deliver
   (d) The capital structure review
9. The first three buckets contain drivers that investors in any commercial operation face. They are risks that arise in business.

10. The fourth bucket, being the capital structure review Fonterra announced in May last year is, in my view, very different. The capital structure changes fall outside of the boundaries of normal commercial investment risk. And they have had a significant and sustained negative impact on the value of our units.

11. As I said earlier in my Chair's address, I remain firmly of the view that Fonterra should have bought the Fund out at fair price, the starting point for which, I would argue, was the $4.60 units were trading at immediately prior to the capital review announcement on 6 May last year.

12. The most surprising point in my 10 years as chair was when Fonterra released consultation material on the capital structure review. That

material, and statements Fonterra made in the associated media interviews, argued that the Shareholders Fund was causing Fonterra shares to be overvalued. The explanation was that ‘farmers think differently to investors. They have more risk from the concentration of capital (meaning capital in their farming operations), and a higher expectation of yield’. Or expressed more technically, farmers have a higher cost of capital than investors in the Fund, and for this reason they expect a higher yield. To achieve that they need to pay less for their shares.

13. This reasoning is highly debatable. But perhaps more importantly, were it to be true then the Fund should not have been formed in the first place. The share value inflation impact that Fonterra complained about for the first time in 2021, if valid, was equally present and relevant back in 2012.It was an aberration of Fonterra’s own making.

14. I was also thrown by Fonterra’s statements to the effect that the Fund’s existence risked loss of farmer control of the co-operative. How that could possibly be so given that the Fund has no voting rights of any kind in Fonterra, and no possible way of obtaining them, remains a mystery. It does however reflect ongoing underlying disquiet by some farmers over the presence of external investors, an issue that history shows was never adequately resolved ahead of the Fund’s formation.

15. So, we found ourselves in the extraordinary position in May last year where the Fund had moved from being a solution to Fonterra’s capital structure problems to being the cause of new and more profound capital structure problems.

16. If I can use an analogy to illustrate my point, it was like having been invited to a long-stay hotel in return for the payment of a pre-paid room rate, then being told 9 years later that you are causing problems for more important guests. You get the impression that you may not be welcome any longer. The manager of the hotel complains loudly that, because you are outsiders, you are prepared to pay a higher room rate than the more important guests. You have had the undesirable effect of bumping the room rate up.

17. To solve this, all rooms will be reduced in size. The market value of rooms will drop as a result. The hotel might also fall out of the top 50 hotel index, further dampening the value of the rooms. And the house bar will be split into two, one for insiders, and a separate one for outsiders, because the combined bar has been causing too much liquidity and higher prices.

18. In the media, Fonterra explained: ‘The current model is incongruous because if we are seeking to maximise share price and have at the same time an intergenerational co-operative, those two things don’t go together. It just doesn’t work. Currently there is a misalignment of investor profiles.’

19. I understand and respect Fonterra’s right to reach that view and to act on it. However, having reached the view that the Trading Among Farmers structure that they designed must be dismantled, because ‘it just doesn’t work’, I am in no doubt that the proper course of action was to provide unit holders with the right to be bought out at that time at fair price. In my book, that is the respect that unit holders deserved. Buying the Fund out, which was Fonterra’s stated preference when it first embarked on the consultation process last year, before subsequently changing its mind, was the principled solution.

20. In further support for my view, I point to the various headlines in Fonterra media releases over the past 18 months. These consistently refer to the proposed new capital structure being good for farmers. I did not see one headline saying that the new capital structure would be good for unit holders.

21. To borrow a well-known Australian colloquialism, Fonterra, I put it to you that unit holders have not had a fair suck of the sav.

Milk price

22. I have spent many hours debating this issue with unit holders, media comentators and others. I remain satisfied that the milk price setting mechanism is transparent and achieves an arm’s length price. I do not

agree with the proposition that this mechanism is skewed against the interests of unit holders, or that there is any form of manipulation of the outcome. However, Fonterra needs to do a better job explaining to stakeholders I explaining the way the milk price is set..

23. In my view, the governance framework around the farmgate milk price is both thorough and impressive. There are a range of checks and balances in place, including oversight under the Dairy Industry Restructuring Act, which includes review by the Commerce Commission. The proposed amendments to DIRA, currently before Parliament, to accommodate the new capital structure further strengthen these checks and balances.

Looking ahead- are there grounds for optimism?

24. Despite my profound disappointment and fundamental disagreement with Fonterra over the treatment of unit holders, I acknowledge that we, the Fund manager, and unit holders, have to play with the cards that have been dealt. The Fund will remain, at least for the foreseeable future. Although its old role as a central component of the TAF arrangements falls away, and the Fund now sits on fundamentally different foundations, it remains as holder of a little under 7% of the economic interest in New Zealand's largest, and strategically most important, company.

25. You have heard this morning Fonterra say that is making solid progress in implementing its strategy and that it is on track to meet its 2030 performance targets. The forecast earnings range for 2023 has been increased to 45 to 60 cents per share. These are good results in the context of the continuing high milk price and should provide scope for respectable dividends. Fonterra has also reaffirmed its commitment to a significant return of capital to shareholders and unit holder on completion of its divestment programme, subject to the Co-ops financial position at the time.

26. I also commend Fonterra on the content of its 2022 results package. It is thorough and clear in terms of the Co-op's plans and its priorities. Long overdue stability is evident. But, of course, execution is vital.

27. Looking ahead, the market will determine if the Fund is a good investment. The primary driver of course will be Fonterra's performance. The vastly more down to earth strategy being pursued by the current board and management seems to be translating into improved results so far. Two factors will be critical to gaining and embedding market confidence and support for investment in the Fund, hopefully including a return of institutional support. First, consistency in strategy and earnings, which will in turn translate into a decent dividend stream. Second, avoidance of the strategic potholes that have undermined value so severely over the past decade.

28. I wish my successor, Mary-Jane Daly, and the new Board all the best in taking the Fund forward.

John Shewan

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