

HD **DAIRY GIANT'S FUNDING FIX**

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Fonterra is developing an **equity** fund which could transform the **dairy** industry, writes Tim Binsted .

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TWO YEARS on from its innovative listing in Australia and New Zealand, **dairy** powerhouse Fonterra is considering a new **equity** fund that could change how the industry is funded.

The **Equity** Partners' Fund was flagged last month with the launch of Fonterra's fifth global **brand** Farm Source; a rewards, farm retail, financial management and technology package for the co-operative's farmer shareholders.

While the announcement was detail light and is early in the consultation phase, the fund would source **equity** from pension funds with long-dated liabilities to invest at farm level.

As last year's de-listing of Australian rural land player PrimeAg highlighted, there is a huge mismatch between the needs of fund managers with quarterly - or even monthly - performance measures and the funding needs of farming enterprises.

Fonterra may participate in the fund itself at the beginning, but it would be an independent entity providing patient capital through the cycle to encourage farmers to grow.

The pension funds are likely to get exposure to yield from the farm without having to operate it and/or some exposure to the value of agricultural land.

Missing piece solution

In the endless debate about Australia's declining **milk** production in the face of booming Asian demand, the Fonterra **equity** fund could be the missing piece for **dairy**. It could also recast how the country thinks about meeting the capital shortfall for the agriculture sector.

While Fonterra chief financial officer Lukas Paravicini is gearing up for early-stage talks on the **equity** fund, he has just flown back to New Zealand after meetings with the **dairy** giant's Australian unit holders. Around 40 per cent of the Fonterra Shareholders' Fund is held by Australian institutions.

Since the fund's \$500 **million** float on the ASX and NZX, there has been lingering uncertainty over how accountable the **company** would be to its new third-party investors. The units give non-farmer investors economic rights but no voting rights, keeping ownership of the co-operative in the hands of its farmers. It's a model Australia's biggest **dairy** processor Murray Goulburn is trying to emulate.

For some fund managers this isn't a problem. Others say they would never **buy** units that don't actually provide ownership of the **company**.

This tension is now being tested as Perpetual, which owns 13.3 per cent of the Shareholders' Fund, is pushing Fonterra to be more disciplined around its capital expenditures. At the September full-year result the **company** said it has \$1.6 **billion** of capex (some of this is stay-in-**business** capex) in the pipeline for 2014-15 and it expects capex will remain elevated for some time.

Fonterra is building a massive new drier at Lichfield, expanding capacity at Pahiatua, and building three new plants at Edendale. The Lichfield plant will be similar in size to Fonterra's Darfield plant, currently the biggest drier in the world.

At full tilt, Darfield can process eight **million** litres of **milk** a day, the same amount as all six of Fonterra's Australian plants combined.

The motivation for these shiny new plants is to provide flexibility, allowing Fonterra to move **milk** to the highest value use and protecting it from volatility in global markets.

Value-add strategy

As a regulated monopoly in New Zealand these investments will generate a return close to the cost of capital.

The main reason fund managers backed Fonterra in the first place is because they believed in its "turning the wheel strategy". Turning the wheel means lifting returns on capital by shifting production toward more value-added products.

Achieving the cost of capital will be dilutive to **group** returns.

Unsurprisingly the two main questions Paravicini dealt with from his Australian investors were around capex and how quickly Fonterra can "turn the wheel".

Fund managers want more transparency and discipline around return hurdles. If Fonterra ignores them it sends a warning to investors in the fund that their lack of voting rights is a serious problem.

In the intense scrutiny that comes with being New Zealand's most important **company**, Fonterra has done a good job balancing the needs of all its stakeholders so it is likely to take the capex feedback on **board**.

While they do deliver lower returns, Paravicini sees commodity products like **milk** powders as a baseline to encourage **milk** production growth, and as a backbone product into markets to then start turning the wheel.

Outside the capex issue there's plenty keeping Fonterra busy.

The **company** is still dealing with the fallout from last year's whey protein concentrate (WPC) scandal, where a batch of product returned a false positive for potentially fatal botulism-causing bacteria. The scandal prompted widespread product recalls and Fonterra was locked out of several markets including **China**, Russia and Sri Lanka.

In the wake of the scare, French food heavyweight Danone cancelled its supply contract with Fonterra and the two companies are now thrashing it out in court.

Bans on some Fonterra products are still in place in **China**, despite the alarm being false. The ongoing ban reflects the dislike big **dairy** importers have for Fonterra's market power.

China's wariness of Fonterra - which supplies about 90 per cent of its whole **milk** powder - is something of a double-edged sword for Australia. Australian **dairy** farmers want a "New Zealand-plus" free trade deal with **China** to emerge from Trade Minister Andrew Robb's current talks. But **China** thinks it made a mistake giving the Kiwi's the deal they have, and the only thing offsetting that is the desire to balance up competition and dilute Fonterra's power.

At Fonterra's full-year result chief executive Theo Spierings said that you can't do **business** in **China** without **Chinese** partners. Shortly before the result Fonterra announced plans to **acquire** 20 per cent of **Chinese** infant food maker Beingmate and for the two companies to set up a joint venture **company** and distribution agreement.

The **Chinese** infant formula market - of which Beingmate has a 10 per cent share - is worth about \$16 **billion** today and is forecast to grow to around \$30 **billion** by 2017.

This deal is a case in point for Fonterra's global-hub strategy to capture as much **milk** in key regions as possible, and find the highest value home for that **milk**.

Higher margin formula

While Fonterra has been on the front foot driving into **China**, it has been reacting to market moves in Australia.

Australia has not been an easy place to do **business** for Fonterra due to fierce competition from rivals and the bruising power of supermarket giants Coles and Woolworths.

Fonterra Australia has been cutting costs and slashing the **brand** portfolio to focus on a smaller number of key brands. Last year Fonterra snapped up Tasmanian yoghurt **business** Tamar Valley which is the final part of the **brand** piece before shifting the focus to product innovation.

Lingering questions also remain over Fonterra's relationship with ASX-listed Bega **Cheese**.

During last year's takeover scrap for Warrnambool **Cheese & Butter**, Fonterra forked out \$50 **million** to take a 10 per cent **stake** in Bega. Fonterra licenses the Bega **brand** in Australia and is the major customer through Bega's Ridge Street **cheese** cut and wrap facility. Fonterra moved to protect its current arrangements and said it has no immediate takeover ambitions for Bega, but the strategic logic of a deal is obvious to everyone. Bega has a 10 per cent shareholder cap, but it won't stay in place forever and chairman Barry Irvin could get it removed immediately if it made sense for the **company**.

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