

FINANCIAL REVIEW

HD **Saputo win restores dairy as big cheese**
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WC 1,345 words
PD 17 January 2014
SN The Australian Financial Review
SC AFNR
ED First
PG 40
LA English
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Chanticleer

Australia's long-neglected and somewhat stagnant **dairy** industry is about to enjoy a capital investment bonanza following a successful takeover of Warrnambool **Cheese & Butter** Factory by Canadian **group** Saputo.

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The takeover has transformed the valuations in the industry and has the potential to change the long-term economics of the **dairy** and **milk** processing sector by injecting about half a **billion** dollars in capital.

The deal has doubled the valuation of all **dairy** companies in Australia. That means the big players, including those companies that failed to take over Warrnambool, will now have a gilt-edged and valuable currency to raise capital or do more deals.

As is usually the case in Australian agriculture, it took the sudden intervention of a foreign player to make local investors realise just how valuable **milk** is as a commodity in both raw and processed form.

It was a similar story with GrainCorp. Foreign grains **group** Archer Daniels Midland bid \$3.4 **billion** and promised to invest \$500 **million** in upgrading local infrastructure. But Treasurer Joe Hockey squashed that bid after split advice from the Foreign Investment Review **Board**.

Saputo will show the advantage of foreign intervention reasonably quickly. It plans to use Warrnambool as the regional production centre for its attack on the **Chinese** market. It had the guts to pay double what local investors were willing to pay on the premise that global demand for **milk** products would outstrip supply within three years because of demand from **China**.

Saputo will be pumping more than \$500 **million** into the **dairy** industry including about \$100 **million** each to Bega **Cheese** and Murray Goulburn in return for their strategic stakes in the **company**.

Bega, which owned 18.8 per cent, accepted the offer on Thursday and Murray Goulburn, which owns 17.7 per cent, is likely to accept in a few days. Once Saputo has more than 50 per cent of the target, its offer will automatically extend for two weeks.

The market clearly believes Saputo will win more than 75 per cent of the target because at that price the Canadians will offer \$9.40 a share. Warrnambool stock closed on Thursday at \$9.40.

If Saputo gets control of 90 per cent of the **company**, it will pay \$9.60 a share. But there is no guarantee that Japanese **group** Kirin, which owns 9.9 per cent of Warrnambool through its Australian subsidiary Lion, will accept the bid.

If it does, it will pick up \$55 **million** from Saputo and make a profit of about \$11 **million**. Those numbers are peanuts in the context of Kirin's revenue and balance sheet.

In other words, the Japanese could hold out for some sort of financial benefit such as long-term contracts with Saputo.

Bega and Murray Goulburn will each make profits of \$70 million on their shareholdings in Warrnambool.

Bega and Murray Goulburn are expected to use the cash from Saputo to crank up their investment in the sector. They want to enhance their export offerings and take advantage of rising demand in Asia. The incentive to improve their manufacturing capabilities is clear from the fact that infant formula sells in China for four times the price in Australia.

Also, Saputo will pay about \$200 million to local dairy farmers and their families who owned shares in Warrnambool. That might end up being reinvested in their farms but given the tough times in the industry it will probably end up as retirement nest eggs.

Hedge funds will pick up the rest of the cash being paid out by Saputo. The hedge funds were very active during the Warrnambool takeover. Some bought in, sold out along the way, then bought in again.

There were multiple opportunities for profits during the takeover because of the extraordinary increase in the valuation of the company.

The bidding started in September last year when Bega kicked off the auction with a bid of \$5.78 in cash and Bega shares.

Once the auction started, there was no stopping it. There have been nine different bids despite the fact that all the way through the board of Warrnambool favoured the offers from Saputo.

The takeover of Warrnambool is perfectly timed for Murray Goulburn. It is due to raise capital this year using synthetic instruments similar to those used by New Zealand dairy co-operative Fonterra. The Kiwis created an innovative way to access capital markets. They preserved the ownership of the business by dairy farmers while allowing outsiders to enjoy the benefits of the company's exposure to Chinese demand.

Fonterra is held up as a shining light in world dairy markets. However, the fact that it is a monopoly carries increased risks. These market concentration risks were highlighted in the past few months when it suffered recalls of its products.

Saputo's entry into the battle for control of Warrnambool was noteworthy because it was up against rival offers from in-market companies, Bega Cheese and Murray Goulburn. Normally, the in-market bidders have a distinct advantage over new entrants. They can allegedly pay more because of the ability for cost cutting because of overlapping activities.

These so called synergy benefits were certainly heavily spruiked by Saputo's rivals.

In fact, the synergy benefits were judged so magnificent by rival bidder Murray Goulburn that it formed the basis of its case before the Australian Competition Tribunal.

Murray Goulburn had previously had a tilt at Warrnambool three years ago only to withdraw when the Australian Competition and Consumer Commission said it believed a takeover would substantially lessen competition.

Hard heads reckon Murray Goulburn should have taken the ACCC head on instead of by passing them and seeking Australia's first merger authorisation from the Tribunal.

The ACCC did not respond kindly to the tribunal application. Some observers even opined that it appeared to be fighting to preserve its relevance when it opposed the national champion arguments put by Murray Goulburn.

It may well be that the Tribunal case will wither on the vine if Murray Goulburn obtains approval from the corporate regulator to withdraw its takeover offer for Warrnambool.

Murray Goulburn's takeover ambitions may not be dimmed by its defeat in the battle for Warrnambool.

It could go after Bega but that is much more difficult than it first looks. Bega has a limit on ownership of its shares of 10 per cent for one shareholder.

That shareholder cap can only be changed if the company's constitution is changed which requires a 75 per cent majority of those voting.

Also, it would seem to be the wrong time to be bidding for Bega considering its market capitalisation has risen by \$480 million to \$700 million in the five months since it launched the bid for Warrnambool.

Even if it does not get bigger by acquisition, Murray Goulburn under chief executive Gary Helou will emerge as a winner. It is cashed up and well positioned to take advantage of the transformation of its capital structure.

The Warrnambool takeover is good for Australia because it will introduce an entrepreneurial player to the market in the shape of Saputo.

This company was founded by Giuseppe Saputo, an Italian who migrated to Canada in 1952. His son, Lino, is chairman and his grandson Lino jnr is the executive of the company now valued at about \$C4.2 billion.

It is ironic that Saputo has managed to expand successfully internationally from a base in Canada. It is one of the most protected milk markets in the world.

The Warrnambool takeover was a boon for bankers, lawyers and public relations firms.

The roll call of bankers and lawyers is as follows: CIMB and Minter Ellison advised Warrnambool; Lazard and Herbert Smith Freehills advised Murray Goulburn; Kidder Williams and Addisons Lawyers advised Bega; Rothschild, Rabobank and Maddocks advised Saputo; Greenhill & Co and King & Wood Mallesons advised Lion and Fonterra was advised by Reunion Capital Partners.

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IN	i4131 : Non-frozen Dairy Products i0 : Agriculture i41 : Food/Beverages/Tobacco i413 : Dairy Products icnp : Consumer Goods ifood : Food Products i416 : Flour/Malt Products
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