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FONTERRA CAPITAL RESTRUCTURE

This proposal is still very much fresh out of its packaging so shareholders are still prodding and poking it to see the strengths and weaknesses. The following outline and comments must be read as a “first glance” with continuing discussions in next months issue of Milklines.

The restructure has three components to it;

1. Strengthening the share structure.
2. Restricted Share Value.
3. Trading Among Farmers.

WHY RESTRUCTURE?

Fonterra wants farmers to at least maintain their shareholding, which is equity in the company. Further to this they wish to have an incentive for farmers to inject extra capital into the business to help growth and reduce the need for outside capital or exposure to redemption risk.

HOW WILL IT WORK?

If you supply a steady 100,000 kg MS you are required to maintain a minimum 100,000 fair value shares. However you can elect as early as December of this year to acquire a further 20% or 20,000 shares for the 09/10 season in this example.

In this case for the 09-10 season you would receive the added value payment on both the 100,000 kg of milksolids supplied, and on the extra 20,000 shares.

If you produced 100,000 kg MS last season, but this season you supply 80,000 kg of milksolids you will be able to elect to retain the 96,000 fair value shares – i.e. 20% of 80,000 kg MS. The milk payment will be on the 80,000 kg and the added value return will be paid on the 80,000 kg MS and the 16,000 extra (dry) shares.

What if you produced 100,000 kg then dropped supply below 80,000 kg MS, lets say 75,000 kg MS. You would only receive the milk payment on the 75,000 kg MS and you would be entitled to

hold 90,000 shares ($75,000 + 20\% = 90,000$) so would get an added value payment on the entire 90,000 shares.

The company are considering the option to not have the surplus 10,000 shares resumed (100,000 – 90,000) but any surplus dry shares would receive no value add payment. A situation farmers might consider if there is a one-off drop in production that will be quickly recovered, and share value is perceived to continue increasing – **but this is not confirmed as an option.**

If milk production is increasing, particularly this season there is an opportunity to buy the matching shares in advance (max 20% of existing shareholding) and thereby pin the price of the shares and get a return on the invested monies – potentially above the cost of funds.

They can buy up to their estimated 2009/10 production or additional “dry” shares up to 120% of estimated production (or any % up to 120%). Shares held above the actual production will need to be held until the end of the 2010/11 season.

How will this affect sharemilkers?

For variable order sharemilkers the impact of this Capital Restructure should be well understood by the New Year. Sharemilking agreements for next season can and should be written with a clear guideline surrounding which portion of the milk and added value payment will be used to determine the sharemilkers revenue.

Given the milk payment will be clearly separated from the payment of added value it would be an option to calculate the sharemilkers revenue as a proportion of the milk payment revenue. The calculation will still allow a variable order sharemilker to be fully remunerated – tensions will only arise if there is an unreasonable shift in milk price versus added value payment within the season. (NB variable order sharemilking agreements must be reviewed annually)

For 50:50 sharemilkers the sharemilking agreement needs to be revisited. There is a risk of uncertainty being created around how the added value is termed. If the added value return is re-named as a “dividend”, then some sharemilking agreements would say this belongs solely to the farm owner, e.g. “dividend on shares”.

Care is needed with the interpretation of this situation. As there is no fundamental change in the components of the milk revenue and added value then the revenue should be equally shared between farm owner and 50-50 sharemilker. The clause surrounding dividend payments should be discussed and if necessary re-negotiated to ensure it is clear.

Where the farm owner and/or sharemilker choose to invest into dry shares then the party who has made the investment gets the return.

It may be possible for the beneficial interests in FVS to be transferred to another party (similar to the old Dairy Equities scheme) by using a suitable derivative instrument. This would mean another party other than the shareholder could extract a return on an investment into dry shares. However the shareholder is responsible for the movement of these shares, NB effect if milk production is reducing and there is a subsequent resumption of shares.

It is also important to note that dry shares would not carry voting rights.

In stage 3 Fonterra hope to establish an exchange whereby shareholders can trade between themselves. This would help Fonterra minimize the cost of administering and transacting the buying and selling of shares. A time frame has not been established for this at it would appear the need for such an exchange would not arise before June 2011. NB Fonterra would still be

expected to underwrite the share value as it will have “business as usual” situations where suppliers exit the industry and have shares resumed.

Dilution – if the added value payment is paid across all shares, wet and dry, then there will be a dilution effect. This is fair in one sense because it gives a return to those who choose to invest into the company. Farmers who choose not to invest will for an interim period achieve a lesser total return.

There will be a dilution effect on payout in the short term due to the shares bought in February attracting a dividend in April. Fonterra estimates that even if everyone bought dry shares up to 120% in December, the short term impact would be to dilute the Value Add Return by about 1 cent. In time, if the extra capital is well utilized by Fonterra in reducing debt and investing in profitable opportunities all shareholders can expect to benefit and the Value Add Return per share should not be materially affected.

Time Line – Farmers and agricultural professionals will be consulted over the next six to seven weeks and a vote will be taken on November 18th.

Q. Would you want to acquire dry shares or generate a position where dry shares are held?

A. If you look at the current situation for the 09-10 season we are expecting a 50 cent added value payment on a \$4.52 share; this is an 11% per annum return on investment. Providing this stays ahead of the cost of capital then farmers with fluctuating milk supply or expected expansion will certainly see favour in this opportunity.

Farmers / borrowers can choose to mitigate part of the investment by fixing an interest rate to fix the borrowing cost and lock in the return.

Q. If I elect to invest into dry shares in December 09, what is the minimum time frame under which this investment will be made?

A. Clarification might be needed but the writer understands an election to invest December 09 will require payment February 10, and the next opportunity to release this capital will be June 2011. So the funds are tied for 16 months. In this period the Added Value return will be received in three portions, April 2010, October 2010 and April 2011. If the dry shares are cashed up at this point a return in the order of 11.6% per annum is possible – which makes the first one-off investment option fairly attractive. (This guesstimate is based on payments of 20 cents, 30 cents and 20 cents respectively, so a 70 cents return on a \$4.52 investment)

Q. Will Fonterra find enough dairy farmers willing to invest back into the company?

A. If you excuse the pun, that really is the million dollar question. Given the current economic volatility there will be some hesitancy. There is the issue of how many eggs get tied up in one basket. A large number of farmers will not have sufficient spare equity to support the investment. But there will be others that look at the 16.5% return and give it the thumbs up. We shouldn't be too surprised if this investment option gets the “nod”.

Q. What will happen to the value of the Fonterra Fair Share, and what impact will this have?

A. For an interim period the value of shares will be give a minimum status of \$4.52 – provided that the freely traded equivalent value does not drop below this level, see note below. Once it has exceeded this level it will be able to track itself according to the ongoing valuation process and/or traded market value of shares if/when established.

If Fonterra retains capital out of payout this will come from the added value portion – so this might have a negative influence. Conversely the company will want both a good share value and a good return on investment – so it will want capital gain with good “dividends” to encourage farmers to keep their investment in the company.

Two further factors influencing added value returns;

1. Transfer cost of milk – this will influence both the milk value and the value add. The rules surrounding this latter issue are not clearly understood.
2. Retained earnings will come out of the value add, which reduces the value add in cash terms but may positively influence share value.

Note: the FVS could reduce below \$4.52. This would happen if the share value based on the current (freely traded) valuation method fell below \$4.52. If this happened the FVS would reduce to the lower level as even without this transition arrangement the share price would have fallen anyway.

WATCH THIS SPACE FOR MORE COMMENTS ON THE RE-STRUCTURE.