



New generation co-operatives and share prices

Fonterra Co-operative Group Limited (Fonterra) is in the process of changing its capital structure with a view to having a farmer market determine the value of the co-operative shares. How well might the shares perform as an investment? We researched two New Zealand new-generation co-operatives and two listed UK dairy companies.

It seems clear that the financial performance of a new-generation co-operative needs to be very strong to support the price of a restricted share close to net asset backing.

The financial performance of the New Zealand new-generation co-operatives studied appears to fall short of that criteria. We are very curious as to the path Fonterra shareholders will take with regard to capital structure and where it heads.

What is a new-generation co-operative?

New-generation co-operatives (NGCs) retain many principles of a traditional co-operative but the model is closer to a conventional investor-owned company (IOC) in the treatment of shareholder capital. There is provision for the shareholder to extract some of the underlying value of the shares.

Membership is defined, i.e. must own shares to use the services of the co-operative. The share contribution and voting rights are directly linked to patronage. There is the potential for realisable capital gain on shares. Any retained earnings are 'owned' by shareholders and are part of the realisable value. Capital contributions are recognised with payments on capital. NGCs tend to be agriculturally based – formed with the objective of adding value to produce supplied by the supplier/shareholder. Not all NGCs have all the above features.

NGCs have different capital structures to traditional co-operatives to achieve one or more of the following:

- reduce or eliminate redemption risk;
- transfer some or most of the wealth created by the co-operative to the shareholder; and
- provide a platform to raise additional capital, if required, from shareholders (or external investors).

There are also many variations on a theme for capital structures and process for NGCs.

Shares in NGCs with the potential to realise value usually come with additional restrictions compared with shares in investor-owned companies. Restricted shares may include one or more of the following conditions:

- who can hold the shares;
- how many shares they can have;
- how the value is to be established;
- a defined process for establishing the amount of a dividend (if any) payable;

- restriction on voting rights; and
- some other conditions.

In addition there may be an established process for the transfer of this class of share when the shareholder exits the co-operative.

The price of a share

There are four main influences on the price of a share:

- *the general economic environment;*
- *company-specific factors;*
- *the restrictions (if any) attached to the share; and*
- *perceptions of the buyers and sellers.*

Interest rates, the rate of economic growth, risk and returns available from alternative investments and policy risk are four major economic drivers influencing the value of shares generally.

Company-specific factors include the risks of the business, and trends in income, profits, dividends and shareholders' funds. The overall financial and management strength of the company are also important.

Conventional companies listed on the stock exchange usually only have one class of share. The rights of the owner of the share are set out in the company constitution and vary little between companies. Ownership is not restricted by number, person or body corporate. There may be statutory and regulatory processes to be followed when the number of shares owned by one entity crosses threshold levels, e.g. becoming a significant shareholder, but that does not prevent the threshold being crossed.

Tradable NGC shares come with combinations of the restrictions listed earlier which arguably lessen their value relative to a share in the same company operating as an IOC. That may limit the size of the market, the liquidity of the share and its price.

Finally, buyers and sellers have different perceptions about the value of any item for sale. That creates a market. The price of shares in a company may represent a dog of a deal to one party but a steal to another.

Accordingly, shares sell at three levels: at a premium, at fair value or at a discount to a recognised benchmark value.

Fair value

Price may not reflect fair value if one or more of the pre-conditions for value do not apply.

Fair value is commonly defined by the willing seller, willing buyer concept. It is the price expected to be paid for a good when both parties are deemed to be informed, willing but not anxious to transact and acting at arms length.

Price may not reflect fair value if one or more of the above pre-conditions do not apply.

The value of a company's shares can be determined in a number of ways. More complex methods are based on the discounted cash flow of future earnings. More immediate indicators are comparisons between the share prices of similar companies or various price to earning ratios such as price to net profit after tax.

Another method is to look at the share price as a ratio of the net asset backing of the share. This paper uses the last method. The figure shown in the statement of financial position for shareholders' funds (SHF) is divided by the number of paid up shares with no adjustment. The assumption is that the balance sheet fairly reflects the company's position. The second assumption is that the assets base creating revenue and backing SHF is appropriate for the business, i.e. there are no underutilised or superfluous assets.

The ratio is helpful for comparison but the answer is very sensitive to small changes in either the numerator or the denominator.

A digression – IFRS adjustments

International Financial Reporting Standards (IFRS) adjustments are complicated and can have significant impact on the bottom-line financial results and position.

They fall into two categories: realised and unrealised gains or losses on the opening fair value of financial instruments. The adjustments also include mark to market on other items such as land, buildings and intangibles. The adjustments can make windfall positive (profit) or negative (loss) contributions to the income statement, the equity account or both. However, mark to market gains or losses one year may be reversed the following year.

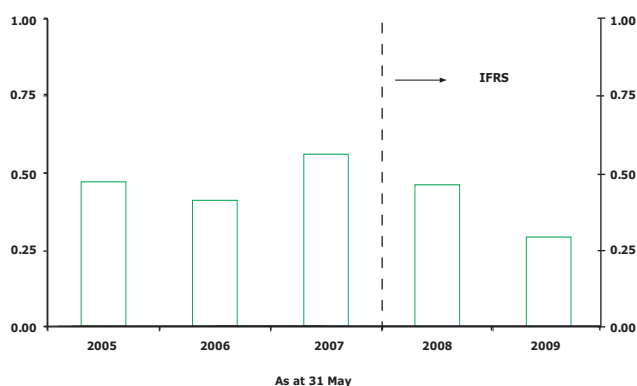
A co-operative with internally traded shares

Livestock Improvement Corporation (LIC) is a New Zealand example of a co-operative with a shareholder-only market for shares. The shares have traded at a significant discount to asset backing.

Graph 1

LIVESTOCK IMPROVEMENT CORPORATION

Share Price as a Ratio of Net Asset Backing



Source: LIC Annual Reports, The National Bank

Share turnover has been very low but the dividend return on the market price has been above average. So why the discount?

LIC is a long-established company providing breeding and animal performance testing services mainly to New Zealand dairy herds. The company grew within the New Zealand Dairy Board. The dissolution of the board led to the ownership of LIC being formalised in March 2002 as a user-owned co-operative.

The capital structure has been changed twice since. Shareholders must own nominal \$1 Co-operative Control Shares in proportion to services provided by the company (equal to four percent of annual purchases). Shareholders at the time of restructuring were also issued with Investment Shares (IS). IS are tradable between shareholders and have no voting rights. Ownership was capped at a maximum of 30 per control share. The cap has been subsequently changed to five percent of the total IS on issue. New shareholders must hold a minimum of two IS per co-operative control share.

The company has over 10,000 shareholders and 29 million IS. Depth in the market is not an issue.

Time series financial data for LIC is clouded by the adoption of the new IFRS in financial year end 2008, which resulted in a major adjustment to LIC's balance sheet. There is also a significant IFRS influence in the 2008 and 2009 statements of financial performance.

Net profit after tax as a percentage of SHF was initially very modest but has improved with some help from IFRS. Dividends as a percentage of SHF have also been low and have remained low. The company has a strong balance sheet with equity of 80 percent or better.

Table 1

SELECTED FINANCIAL PARAMETERS FOR LIC

| YEAR END 31 MAY | NPAT % SHF | DIVIDEND PERCENT OF | | NET ASSET BACKING \$/SHARE | SHARE PRICE AT BALANCE DATE (\$) |
|--------------------|------------------|------------------------|----------------|----------------------------------|---|
| | | SHF | SHARE PRICE | | |
| 2003 | 3.7 | 1.9 | | | |
| 2004 | 4.9 | - | | 3.21 | |
| 2005 | 5.6 | 7.8 | 17.3 | 3.13 | 1.46 |
| 2006 | 7.8 | 6.6 | 16.6 | 3.16 | 1.30 |
| 2007 | 9.7 | 7.9 | 14.7 | 3.22 | 1.80 |
| IFRS | | | | | |
| 2007 | 13.1 | 5.4 | 14.7 | 4.90 | 1.80 |
| 2008 | 9.5 | 2.8 | 6.0 | 5.54 | 1.80 |
| 2009 | 13.8 | 3.7 | 12.9 | 6.07 | 2.56 |

Source: LIC Annual Reports, The National Bank

Directors (and shareholders) face a dilemma. Positive IFRS adjustments can add to profit and wealth but IFRS adjustments can be negative. They are not necessarily cash. The split between dividends and retention should reflect that and arguably do for LIC in 2008 and 2009. (Note again that the 2007 IFRS figures are a restatement of the financials for that year, well after the event.)

Net asset backing per share was only growing at a very slow rate pre IFRS. The share price has gone up – only slower than the net assets backing, running the share premium ratio down.

Whatever the reasons, LIC shares trade at a discount. That phenomenon is not just a feature of LIC shares. Agriculturally based and many other IOC company shares trade at a discount to net asset backing, and often for extended periods.

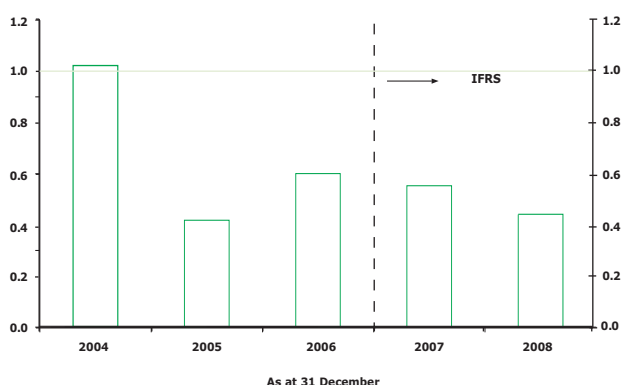
A hybrid

Satara Co-operative Group Limited (Satara) is a New Zealand example of a co-operative with a mixed shareholding of user shareholders, investors and tradable shares. Its shares have also traded at a significant discount to asset backing.

Graph 2

SATARA CO-OPERATIVE

Share Price as a Ratio of Net Asset Backing



Source: Annual Reports, The National Bank

Satara’s principal business is providing packing and cool storage for its grower shareholders. Turnover was \$62 million for year end December 2008.

The company started business in 1971 and has evolved through several mergers and acquisitions. It became a hybrid co-operative in 1999 and listed in 2004. Grower shareholders hold \$1 par value transactor shares in proportion to the volume of fruit supplied and 60 percent of voting rights. Initially, grower shareholders held all the investor shares on what turned out to be a thin market. Now, 268 grower shareholders and investors hold 16.3 million investor shares which are traded on the New Zealand stock exchange. Investor share voting rights are restricted to 40 percent of the total shares (transactor and investment) on issue.

Table 2

COMPARATIVE FINANCIAL INDICATORS FOR SATARA AND SEEKA

| YEAR | REVENUE \$M | | NPAT % SHF | | DIVIDEND % | SHARE PRICE |
|----------------|-------------|-------|------------|------------|------------|-------------|
| | SATARA | SEEKA | SATARA | SEEKA | SATARA* | SEEKA |
| 04/05 | 54.1 | 57.1 | 15.0 | 9.5 | 4.2 | 2.1 |
| 05/06 | 51.5 | 97.8 | 5.3 | 8.6 | 7.5 | 5.3 |
| 06/07 | 55.5 | 95.5 | 8.5 | 5.4 | 2.6 | 5.0 |
| 07/08 | 53.5 | 106.9 | 6.0 | 4.9 | 4.7 | 4.6 |
| 08/09 | 53.2 | 107.5 | 8.6 | 7.2 | 3.4 | 5.4 |
| Average | | | 8.7 | 7.1 | 4.5 | 4.5 |

Source: Annual Reports, The National Bank
*Excludes rebate on transactor shares

There is an established process for calculating rebates for transactor shares and the dividend for investor shares. Numbers traded are highly variable and intermittent. Shares initially traded around \$1.30 at listing and have ranged from \$0.58 to \$1.60.

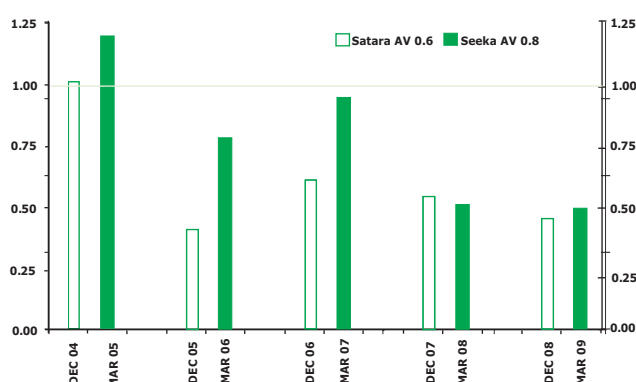
So, is the discount relative to asset backing a function of the share structure, the financial performance of the company, an industry issue (risk of horticulture), some other factor or a combination of above?

There is a comparable example to help try and answer these questions. Seeka Kiwifruit Industries Limited (Seeka) is a listed IOC company in the same general business as Satara, albeit now on a larger scale. Seeka began life in the late 1970s as a company listed on the secondary board and moved to a formal listing in 2003. It has just over 800 shareholders with 12.6 million shares. Its shares have also traded at a discount to net asset backing.

Graph 3

SHARE PRICE PREMIUM

Share Price as a Ratio of Net Asset Backing



Source: Annual Reports, The National Bank

The Seeka share price premium has averaged 20 percent more than Satara over five years although both have been very similar for the last two years. (Data is grouped to align different balance dates with the same growing season.)

There is little difference in the high level financial performance indicators between the companies. Seeka’s revenue jumped in year end March 2006 following the acquisition of Bridge Cool Group.

NPAT and dividends as a percentage of share price are similar, and neither could be classed as outstanding.

The rate of growth in net asset backing over five years has been faster for Satara than Seeka (55 percent compared with 18). Shareholders' equity in both companies is acceptable (45 to 55 percent) and not greatly different. The pool of shareholders is small.

Fruit loss in 2006 was a big issue and cost to the industry. It was still significant but a less so in 2007 and 2008. Bigger industry issues might answer part of the question regarding discounted share prices.

Conclusion: A share premium or discount is more than just a function of capital structure and financial performance.

But are the share discounts for Satara and Seeka the result of the financial performance of the companies or a reflection of investors' perceptions about industry risk? How has the share price of Zespri Group Limited (Zespri) fared over the same period?

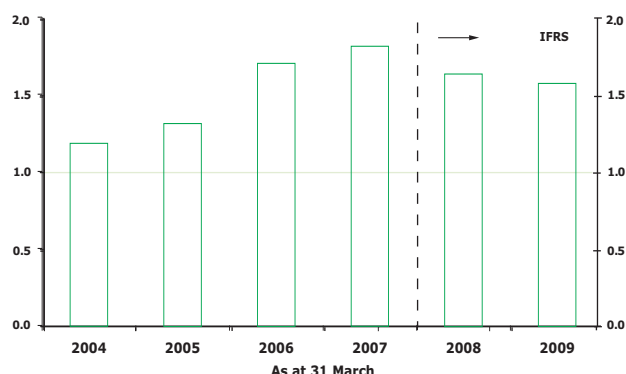
Private company

The price premium for Zespri has been significant on what are restricted shares. High dividends may well be a driver.

Graph 4

ZESPRI GROUP LIMITED

Share Price as a Ratio of Net Asset Backing



Source: Annual Reports, The National Bank

First up, we have to say that Zespri Group Limited (Zespri) is in a different part of the industry to Seeka and Satara. Second while Zespri is owned by kiwifruit growers, it is not a co-operative or a hybrid. It is a privately owned company with a shareholder-only market for shares.

Zespri was formed in 2000 when the New Zealand Kiwifruit Marketing Board was disestablished. Its main activity is consignment selling of kiwifruit produced by shareholder growers.

Shares were issued to growers at \$1 in proportion to supply at that time and in a mix of fully and partially paid. At last balance date, 2,257 shareholders held 24.1 million fully paid shares. Only growers can now participate in share issues. Voting rights are linked to the volume of fruit supplied that is backed by shares held by the shareholder. Between three and five percent of shares change hands a year. Not all sales are 'arm's length' transactions as they include family transfers, etc.

Zespri turnover for year end 31 March 2009 was \$1.5 billion. IFRS impacts on profit have been small as the hedging risk is directly carried by suppliers. Zespri's net profit as a percentage of sales might seem to be low. But it is a good return on SHF which are small relative to turnover. Zespri has a very low investment in fixed assets. SHF have been a reasonable 40 to 50 percent of total assets.

Table 3

SELECTED FINANCIAL INDICATORS FOR ZESPRI

| YEAR END 31 MAY | NPAT % | | DIVIDEND % NPAT | DIVIDEND % MARKET PRICE |
|--------------------|-----------|------|-----------------------|-------------------------------|
| | SALES | SHF | | |
| 2004 | 2.5 | 42.5 | 198 | |
| 2005 | 2.6 | 34.4 | 60 | |
| 2006 | 2.6 | 36.3 | 108 | 23.3 |
| 2007 | 1.9 | 32.0 | 122 | 21.4 |
| IFRS | | | | |
| 2008 | 1.7 | 28.9 | 98 | 17.3 |
| 2009 | 1.9 | 32.3 | 76 | 15.7 |

Source: Annual Reports, The National Bank

The proportion of NPAT paid as dividends has been high. End result: very good dividends on the market value of the share at balance date even if the trend is down. The four-year average is 19.4 percent compared to LIC with 12.5 percent over the same time period. Significant – but enough to create the difference in the share price premium? Longer term, Zespri dividends need to be less than the four-year average of 100 percent NPAT – closer to the 2009 figure?.

Qualified conclusion:

A consistent high dividend policy may soften any negative perceptions of industry issues and/or the effect a restricted share may have on the price of a share.

The qualification

There are a few important differences between LIC and Zespri.

Is there an inherent demand for Zespri shares? Zespri provides over 90 percent of the kiwifruit orchard revenue. The number of shares is (currently) capped. There is no need for growers to hold shares in Zespri but there is pressure to have a proportional share of investment in the marketing company.

In contrast, is there only a very low inherent demand for tradable LIC shares? Dairy farmers have a choice of companies supplying breeding services. The service provided is about five percent of farm working expenses – important but not major compared with over 90 percent of income. There is no requirement to hold investor shares above the minimum standard and investment shares carry no voting rights.

So where does that leave the potential premium/discount on Fonterra restricted shares? We digress again and look at two publicly listed UK dairy companies for another comparison.

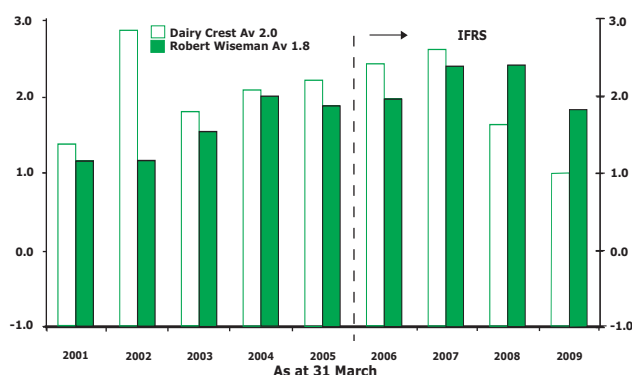
The listed company

The average share price premium of two UK-listed dairy companies was 1.9 times book value but with a range from 1.0 to 2.6. These premiums were obtained in extraordinary times.

Graph 5

SHARE PREMIUM

Expressed as the Ratio of Price to Book Value



Source: Annual Reports, The National Bank

Dairy Crest Group Plc and Robert Wiseman Dairies Plc are two near operationally equivalent and listed UK-based dairy companies. They are also similar in concept to Fonterra in that they acquire, process and sell milk and milk products.

Dairy Crest Group Plc fell out of the restructuring of the Milk Marketing Board in the mid 1990s. It was listed in 1996 and has since expanded by acquisition and organic growth to now be one of the largest dairy companies in the UK. It deals in liquid milk, chilled liquid milk products and cheese. Turnover for the financial year end March 2009 was £1.6 billion.

Robert Wiseman Dairies Plc is a long established company (1947) which listed in 1994. It still has significant family involvement and is more focused on the liquid milk market. Turnover for financial year end 1 April 2009 was £848 million and growth has been steady.

Both operate predominantly within the UK.

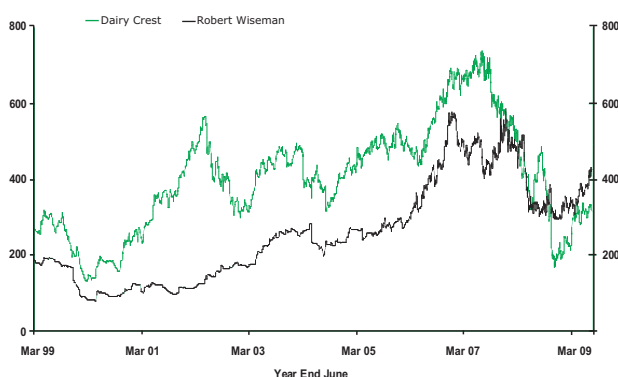
The share price of both companies exhibited wide variation over the period concerned, both up and down.

They have broadly similar income and asset growth histories. Profit margins are also similar in an industry which has had financial failures in the period studied.

Graph 6

HISTORY OF MARKET PRICE

p/share



Source: Bloomberg Reuters, The National Bank

Table 4

SOME AVERAGE FINANCIAL INDICATORS FOR TWO UK DAIRY COMPANIES

| INDICATOR | DAIRY CREST | ROBERT WISEMAN |
|------------------------------------|-------------|----------------|
| Percent Shareholders' Funds | | |
| Net Profit | 14.9 | 15.6 |
| Dividend | 7.8 | 5.6 |
| Retained | 7.1 | 10.0 |
| Other | | |
| Equity % | 30 | 50 |
| Intangible Asset % Total Assets | 41 | 1 |
| Growth in Net Asset Backing % | 6 | 12 |

Source: Annual Reports, The National Bank

The growth in the net asset backing of Robert Wiseman shares has been faster than Dairy Crest (+106 compared with 57 percent).

So while the average share price for these two companies has been near twice asset backing, it was achieved in what is now seen as an exceptional period of economic history. It is unlikely that the combination of high growth rate of global credit and low interest rates experienced between 2000 and mid 2009 will be seen again for quite some time. Perhaps the premiums over net asset backing obtained in 2001 (1.2 to 1.4) are more realistic long-run indicators.

The market, however, does not agree, particularly for Robert Wiseman. The increase in Robert Wiseman's share price since 1 April 2009 takes its premium to 2.6 times its net asset backing at balance date, when the ratio was 1.8. By contrast, the increase in the price of Dairy Crest has been more modest. The ratio has gone from 1.0 in March to 1.3 in January 2010. Such is the influence of market perception.

There are two New Zealand dairy company examples with tradable shares but these were discarded for this paper as they were/are in start-up mode with insufficient history to obtain a consistent view. They are Open Country Dairies, formerly Open Country Cheese and now a private company, and Synlait.

Share premium ratios for Fonterra

The various Fonterra share value premiums sit between the lower end of ratios calculated for the two UK dairy companies and the discounted ratios of the two New Zealand NGCs.

Grant Samuel provided two valuations of Fonterra shares for the Fonterra Board and Shareholders' Council in December 2009. One was a fair value range of \$4.72 to \$5.48/share (mid point \$5.10) with a second restricted share value range of \$3.54 to \$4.10 (mid point \$3.92). The restricted value includes the assumption that a well-functioning farmer-only market operates for the Fonterra shares. The Fonterra Board determined the value of the share at \$4.52. The results of expressing the values as a ratio of our calculated net asset backing are shown in the next table.

The Fonterra fair value premium sits in the lower end of the ratios calculated for the two UK dairy companies studied. The restricted value premium sits above that recently obtained by Satara and LIC.

Table 5

THE POTENTIAL FONTERRA SHARE PREMIUM AT VARIOUS VALUES

| LEVEL | VALUE (\$) | RATIO* |
|-------------------|------------|--------|
| Fair Value | | |
| Upper | 5.48 | 1.40 |
| Mid | 5.10 | 1.30 |
| Lower | 4.72 | 1.20 |
| Fixed | 4.52 | 1.15 |
| Restricted | | |
| Upper | 4.10 | 1.05 |
| Mid | 3.92 | 1.00 |
| Lower | 3.54 | 0.90 |

Source: Fonterra, The National Bank
 *Ratio of value to \$3.88 (shareholders' funds/share) rounded to nearest 0.05.

Implications so far

It is clear that to obtain a share price premium the company needs to have all of the following:

- good profitability;
- a dividend that provides a good return on the share price;
- build net asset backing;
- have a share with no restrictions attached;
- have an underlying demand for the shares; and
- have some depth to the market.

The number of companies reviewed is small but how well does Fonterra meet the criteria?

Fonterra

Fonterra is a defined membership co-operative. A supplier must hold shares in Fonterra matched to supply on a one-to-one basis – one share per kilogram of milk solids (kg ms).

Capital restructuring to date now allows a supplier to hold up to 1.2 shares per kg ms. The proposal is to allow an internal shareholder market to establish the value of all shares. A dividend will be paid on all shares after paying for milk supplied and retaining a target range of 25 to 35 percent of the distributable profit within the business. Voting will remain tied to supply.

Fonterra financial indicators

Fonterra's recent financial history is assessed as not likely to create a share price premium.

The analysis in this paper has focused on profitability, dividend returns and policy, company equity and growth of the net asset backing of the company.

The co-operative financial model blurs direct comparisons between Fonterra's profit and that of an IOC. The Fonterra terminology and method of deriving the value-add payment (as the equivalent of a dividend) has also changed over time and been quite variable year to year. Terminology changed again in 2009 to 'distributable profit'. 'Value add' and 'distributable profit' have been treated as one and the same in Table 5.

Core available profit and dividends as a percentage of SHF are modest. But retained earnings by Fonterra have been low and the underlying net asset backing/share little changed since 2002. Annual positive contributions from IFRS adjustments have been a significant boost to overall financial performance.

Shareholder equity was 34 percent and intangibles made up 20 percent of assets at 31 July 2009.

Table 6

FONTERRA DISTRIBUTABLE PROFITS AND RETAINED EARNINGS 2007 TO 2009

| DESCRIPTOR | 31 MAY 2007 | 31 JULY 2008 | 31 JULY 2009 |
|----------------------------------|-------------|--------------|--------------|
| Cents per kg ms | | | |
| Core Avail Distributable Profit* | 56 | 17 | 32 |
| Less | | | |
| 'Dividend' paid | 59 | 7 | 48 |
| Core Avail to be Retained | (2) | 10 | (16) |
| Plus | | | |
| IFRS | 24 | (7) | 40 |
| Actual Retained Earnings | 22 | 4 | 24 |
| Shareholder Equity (%) | 36 | 29 | 34 |
| Shareholders' Funds (cents) | 390 | 358 | 388 |
| Fair Value of Share (cents) | 679 | 557 | 510 |
| As Percentage SHF | | | |
| Core Avail Dist Profit | 14.4 | 4.7 | 8.2 |
| Dividend | 15.1 | 2.0 | 12.4 |
| Core Available for Retention | (0.5) | 2.8 | (4.1) |
| Actual Retained | 5.6 | 1.1 | 6.2 |
| Dividend % Fair Value | 8.7 | 1.3 | 9.4 |

Source: Derived from Fonterra Annual Reports. The National Bank
 Notes: May not add due to rounding.
 *Core available distributable profit is defined as sales plus other income less the sum of cost of sales, depreciation, interest, tax and foreign exchange gains/losses. It excludes IFRS adjustments.

To be fair, the underlying financial results of the other two New Zealand dairy co-operatives have also not been good when measured against the two listed UK dairy companies studied.

Table 7

NEW ZEALAND DAIRY CO-OPERATIVES' AVERAGE RETAINED EARNINGS (2007 TO 2009)

| DESCRIPTOR | FONTERRA | WESTLAND | TATUA |
|-----------------------------------|-----------|-------------|-----------|
| Cents per kg ms | | | |
| Core Avail to be Retained | (3) | (15) | 22 |
| Plus | | | |
| IFRS | 19 | 5 | 31 |
| Actual Retained Earnings | 16 | (11) | 53 |
| Shareholder Equity (%) | 33 | 58 | 55 |
| Shareholders' Funds/share (cents) | 379 | 415 | 573 |
| As Percentage SHF | | | |
| Core Avail Dist Profit | 9.1 | NA | NA |
| Core Available for Retention | (0.8) | (3.6) | 3.8 |
| Actual Retained | 4.3 | (2.7) | 9.2 |

Source: Derived from Fonterra Annual Reports. The National Bank
 Notes: May not add due to rounding.

The dilemma

Different capital structures do not absolve a company from the need to achieve sustainable financial performance. And there lies the circular rub. Shareholders of a co-operative want its service at the best rate or pay the highest price to grow their own business. The performance of the co-operative tends to be secondary but the co-operative has to perform well to provide that low cost service or top income.

A NGC adds to these tensions – especially if there is defined membership and investor shareholders’.

New Zealand dairy co-operatives have got away with low retained earnings because growing the business via increased milk supply requires a matching capital contribution from the farmer.

Other implications for New Zealand dairy co-operatives

The research and analysis presented in this paper suggests that retained earnings are low. What do the parameters look like for the three co-operatives to have a financial performance comparable with the two listed UK companies studied?

Start with profit. That is the main driver of the amount available for retention and a dividend. The two listed UK dairy companies studied are averaging NPAT around 15 percent of shareholders’ funds *before IFRS adjustments*.

Dividend policies for all companies vary between years. New or expanding companies tend to retain a high proportion of NPAT within the business (60 percent plus). Mature companies with strong balance sheets might only retain 20 to 30 percent.

The next table shows the impact of applying a benchmark profit, dividend & retained earnings policy across all three New Zealand co-operatives. Of course, there are several combinations of the three indications that would be used.

Table 8

DESIRABLE FINANCIAL INDICATORS FOR NEW ZEALAND DAIRY CO-OPERATIVES

| DESCRIPTOR | FONTERRA | WESTLAND | TATUA |
|----------------------------------|----------|----------|-------|
| Cents/share | | | |
| Shareholders’ Funds 2009 | 388 | 388 | 613 |
| Core NPAT (15 percent SHF) | 58 | 58 | 92 |
| Dividend (70 percent NPAT) | 40 | 40* | 64* |
| Retained (30 percent NPAT) | 18 | 18 | 28 |
| Core Avail Retention Past | | | |
| Three Year Av | (3) | (15) | 22 |
| As Percentage SHF | | | |
| Dividend | 10 | 10 | 10 |
| Retained | 5 | 5 | 5 |

Source: Derived from Annual Reports. The National Bank

Note: * Implied dividend. Westland and Tatua do not declare a dividend as such. It is part of the milk price.

Fonterra has indicated its intent to pay 65 to 75 percent of the amount available for distributable profit (NPAT) as a dividend (with the usual commercial caveats).

That would equate between \$0.35 and \$0.45/kg ms of our implied 15 percent return. A mid point of 70 percent has been used across all three co-operatives for the purpose of analysis.

Next consider the amount of retained profits. Our implied required 15 percent return on SHF and 70 percent of that distributed leaves a retained profit around five percent of shareholders’ funds. That is a big improvement on recent history but still a low level of retained profit compared with the seven to 10 percent retained on average by Dairy Crest and Robert Wiseman.

A low rate of retained earnings implies a slow increase in the net asset backing of the share and a slower rate of overall company growth.

Retaining a higher level of earnings implies a higher NPAT or a lower dividend. Generating that higher level of pre-IFRS profit on a formula-based milk price may be a challenge for Fonterra. The question is, “Just how fast do the co-operatives want to grow and in which direction?”

One alternative for providing adequate capital for growth is to expand the New Zealand milk supply base. The Fonterra shareholder increasing supply is now required to contribute \$4.52/additional kg ms. Milk supply has to grow at around three percent per annum to get the combined retained earning and capital contribution of shareholders up to the benchmark of seven to 10 percent per annum of shareholders’ funds. Westland and Tatua have a lower cost of shares and would need a faster milk supply growth rate to reach the benchmark. The appetite of New Zealand dairy farmers to expand production at those rates may now have diminished.

Conversely, growing the company without adding to supply (i.e. acquiring another company) implies acquiring a higher level of retained earnings or slower growth.

Conclusions

This paper shows that share price premiums/discounts over net asset backing are quite variable between companies and for the same company over time.

Whether the shares traded at a premium or discount to a benchmark was not just a function of capital structure or financial performance. Capital structure may influence the price of a share but perceptions of the industry may override that influence.

A high dividend may offset the potential negative influences of a specific capital structure on the share price.

It is clear. A company needs more than a well rounded financial performance to obtain a premium share price.

It is suggested that the financial performance of a NGC with a restricted share needs to be very strong to support a share price close to net asset backing. NGCs have additional challenges to achieve both these outcomes.

Kevin Wilson ("Investment Adviser")

This document was prepared as at 3 March 2010

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Qualification: Degree of Agricultural Science Lincoln.

Date obtained: 1970. The Investment Adviser keeps the knowledge obtained from those qualifications up to date by reading relevant industry publications and attending both internal and external seminars and workshops.

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Text finalised 3 March 2010

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