

NZ's Dairy Sector Institutions

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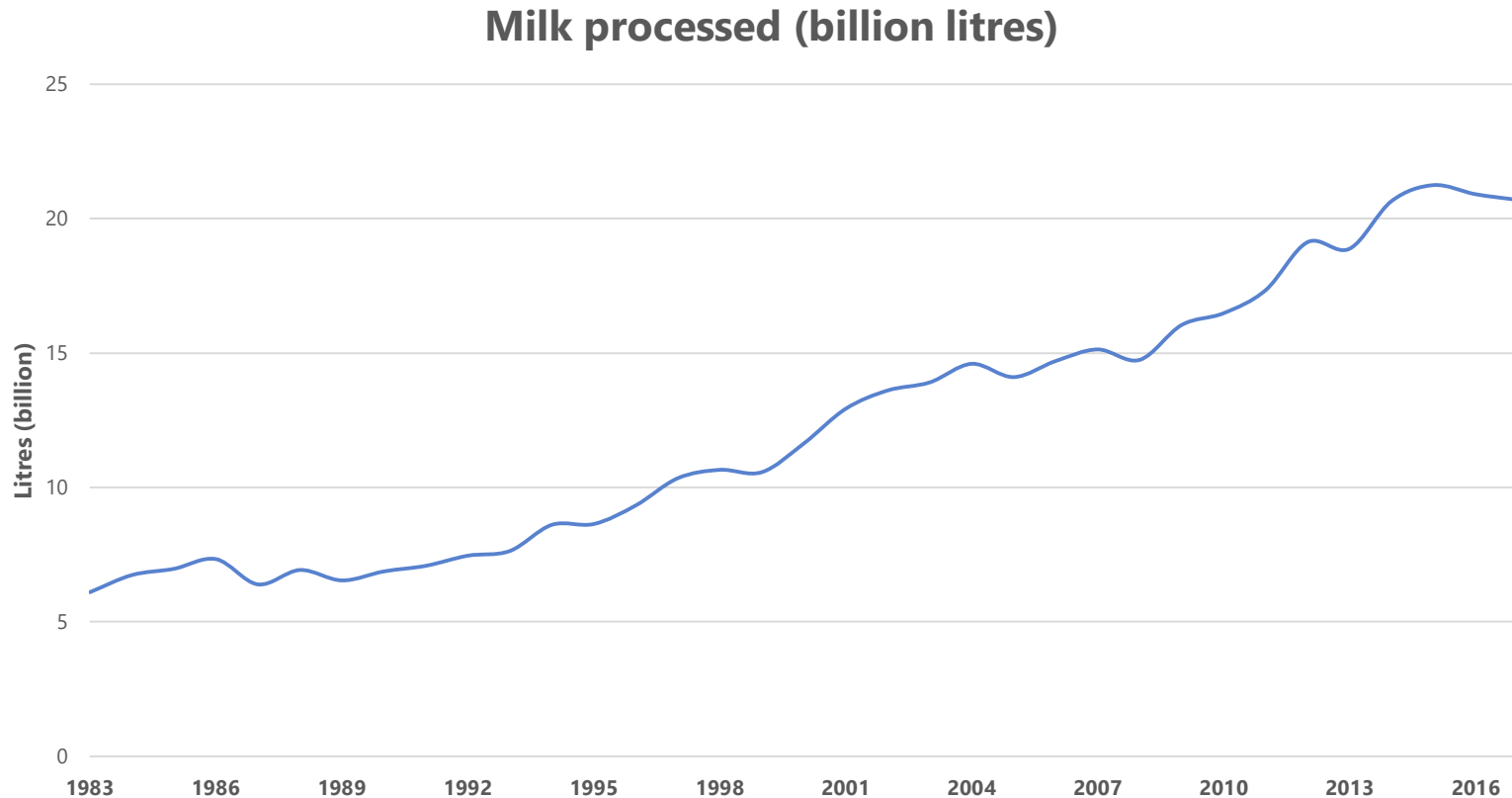
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1. What did DIRA do?
2. Has DIRA worked?
3. Is DIRA still needed?

1. What Did DIRA Do?

1. Created a near-monopsony for Fonterra at the farm-gate
2. Removed the monopsony of the Dairy Board at the factory-gate
3. Preserved competition in the domestic dairy-products market

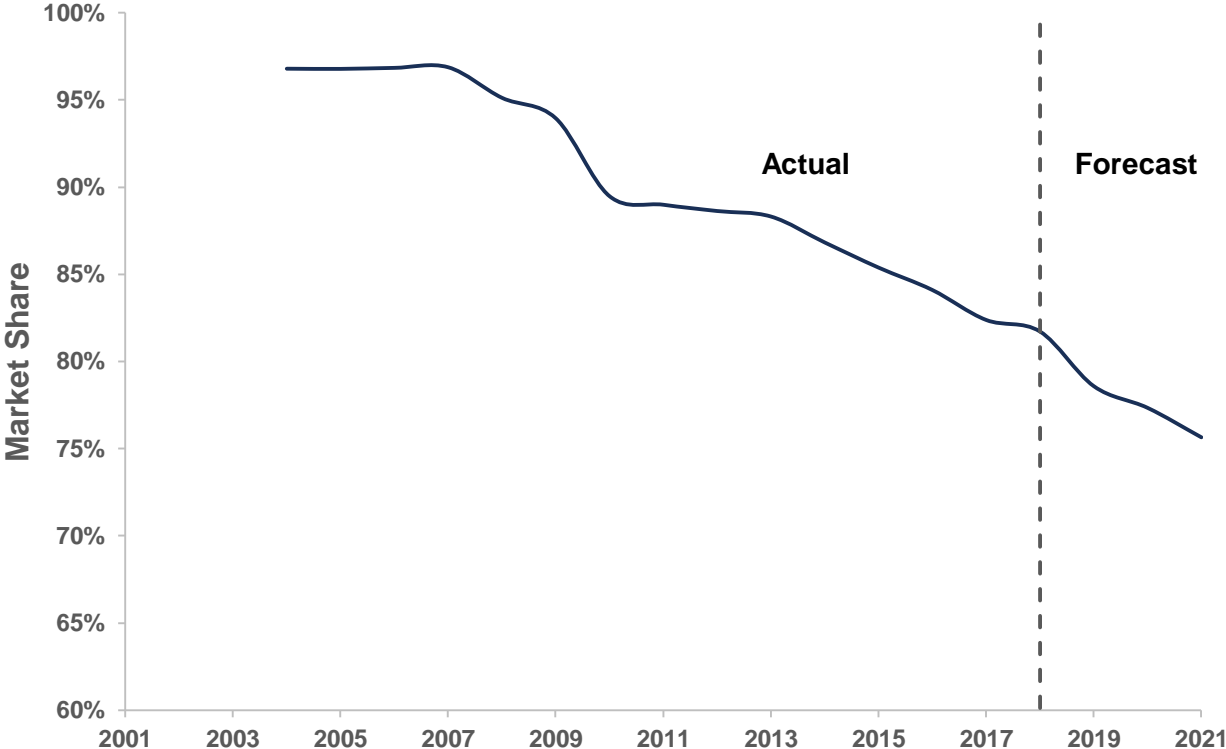
2. Has DIRA Worked?



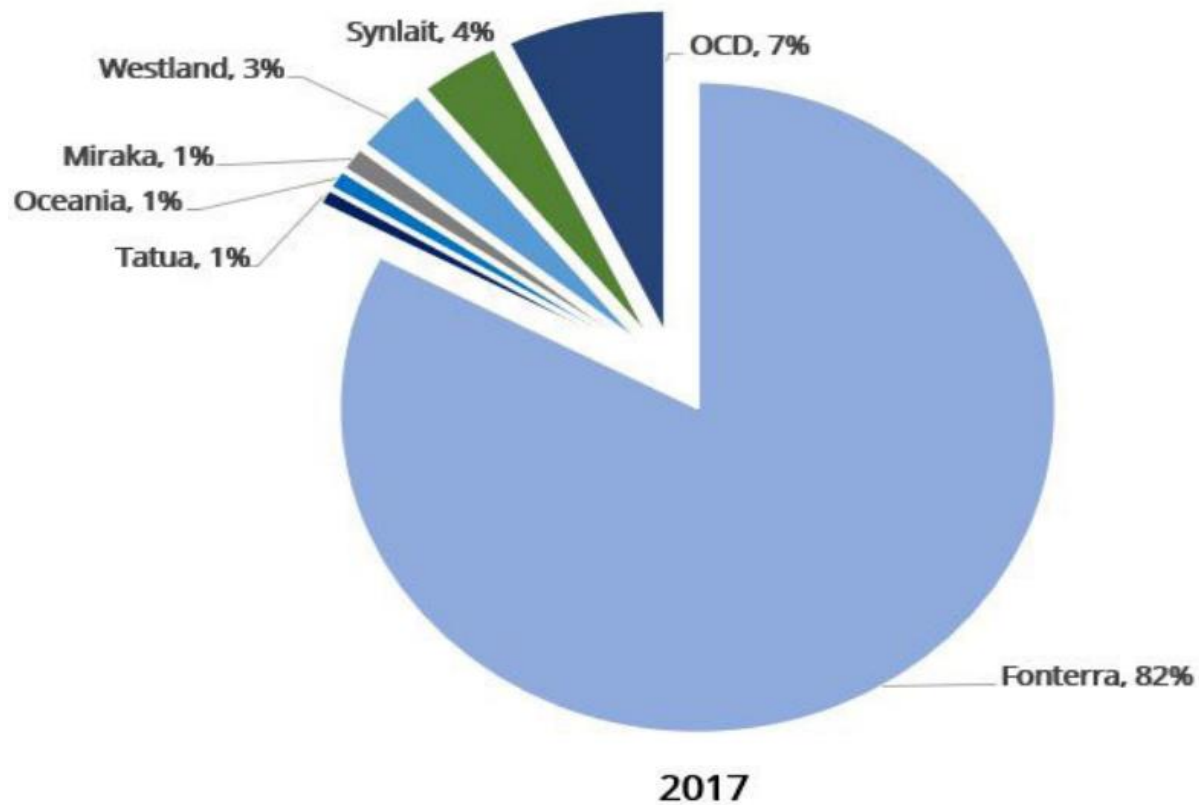
Growth in the sector until reaching peak-cow in approx. 2015-16

Fonterra's Place in the Sector

Fonterra's Farmgate Market Share

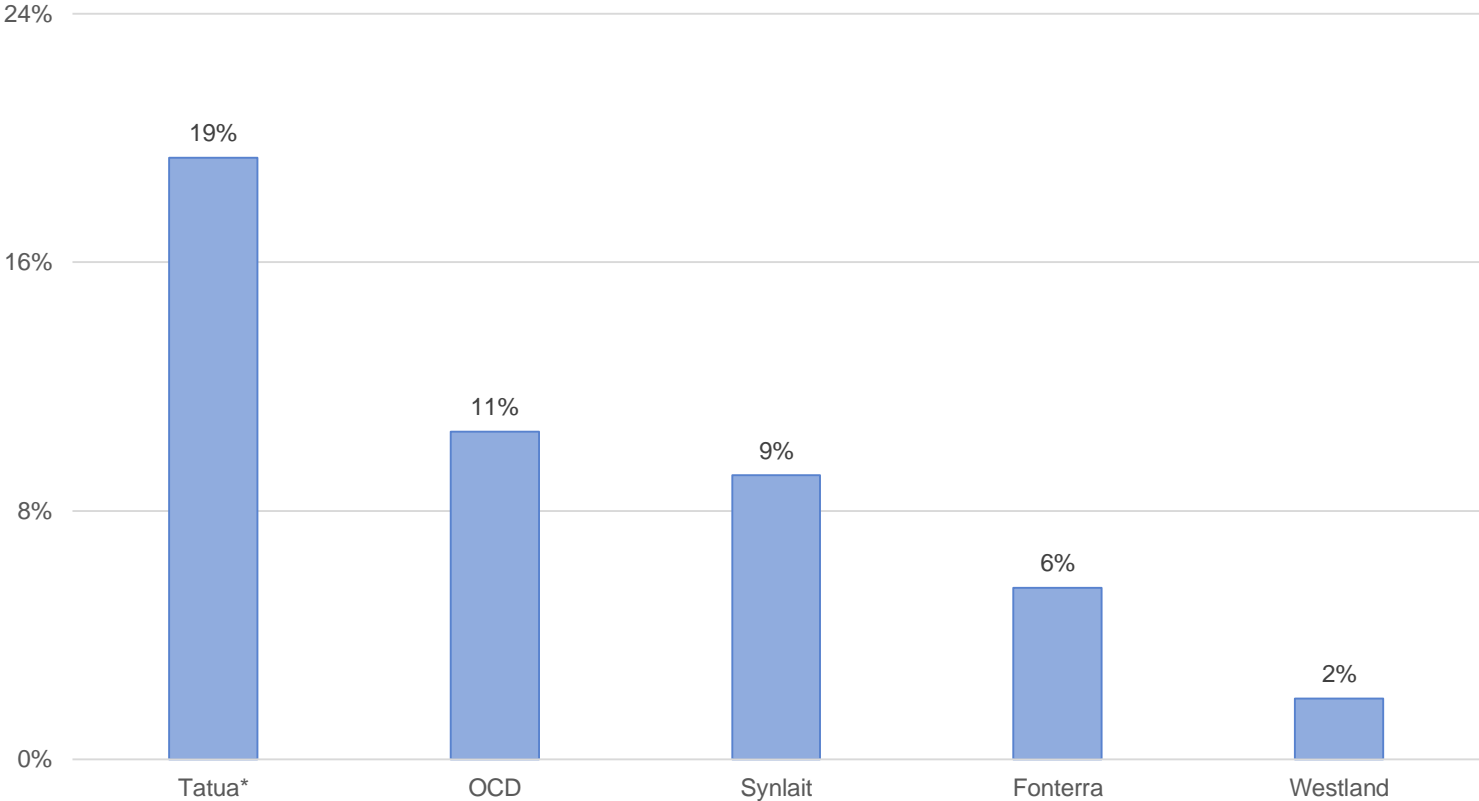


Increasing Competition

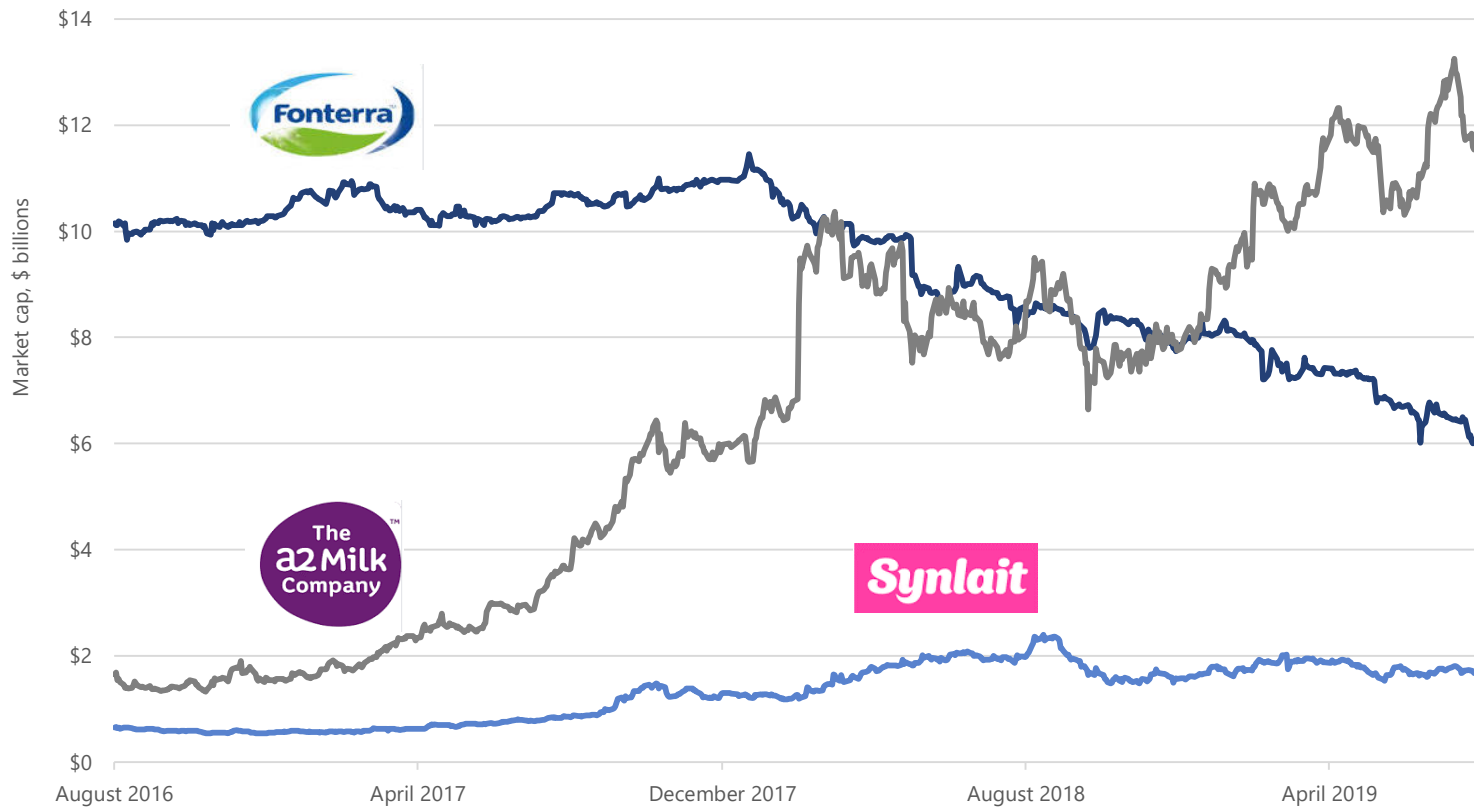


Dairy Processors' Performance

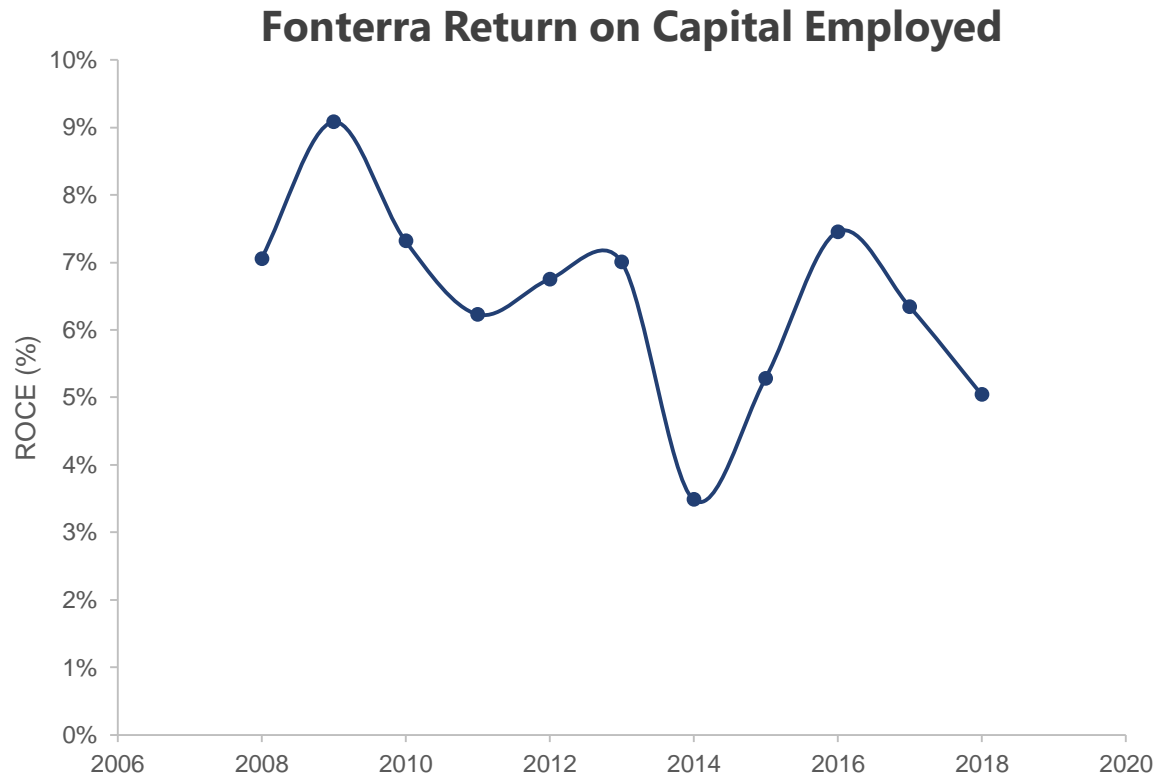
Average Return on Capital Employed, 2014-2018



Market Capitalisation



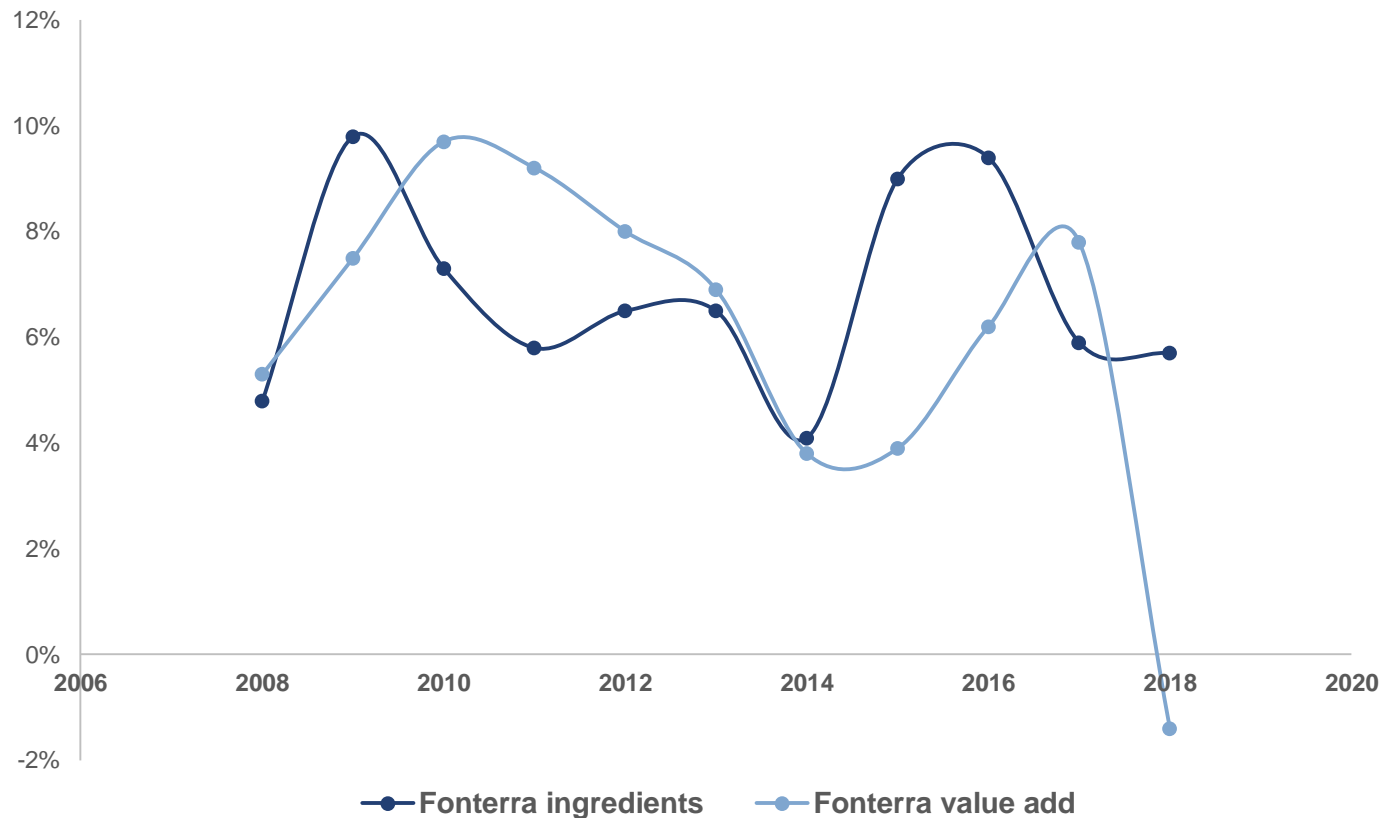
Fonterra's Financial Performance



- Downward trend in performance

Fonterra: Commodities vs "Value Add"

Return on Capital Employed



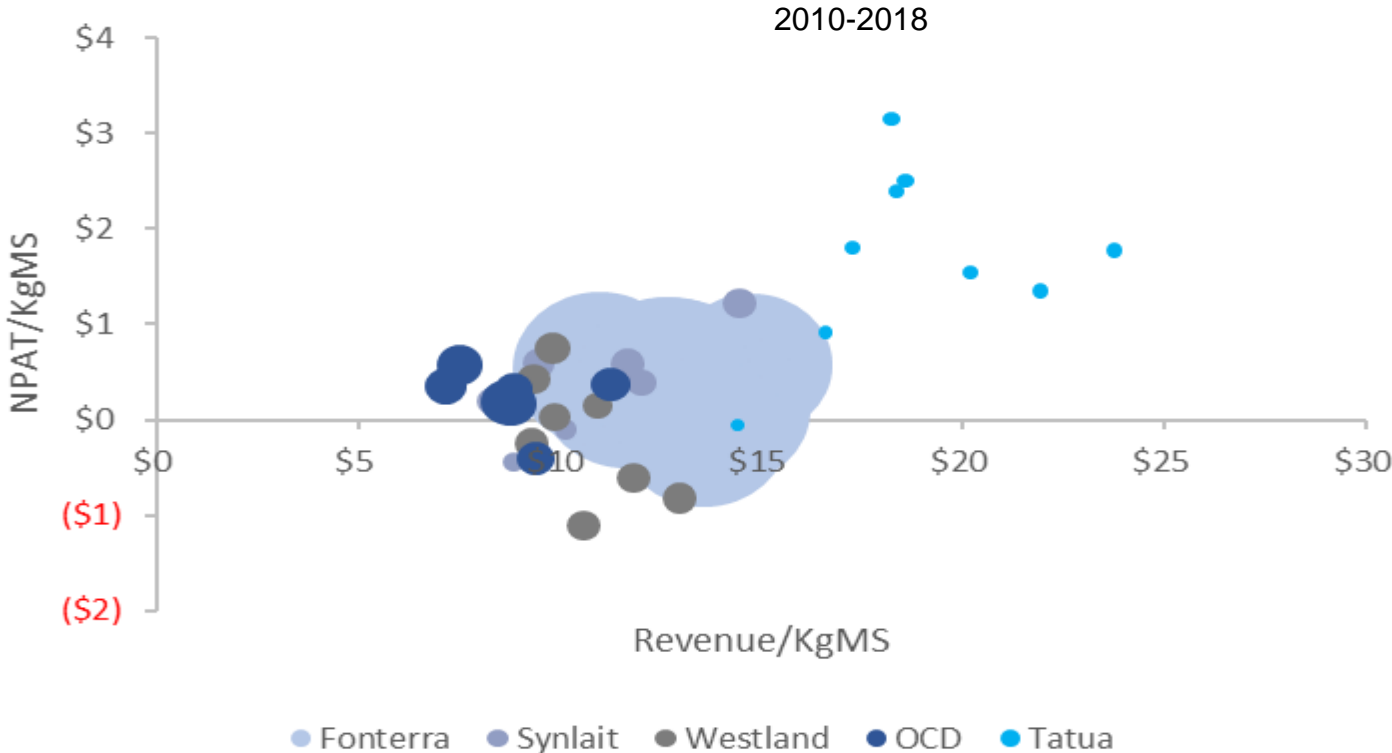
Source: Northington Partners and TDB Advisory analysis

www.tdb.co.nz

What went wrong at Fonterra?

- Structure or Strategy?
- Co-op structure not inherently flawed: but
 - sources of capital limited
 - agency costs increase with size
- Was there a clear strategy? volume/commodity and “value-add” – both are capital intensive
- Fonterra’s structure did not match its strategy

Adding value vs adding costs



Excluding Tatua, there is no clear relationship between economic value (NPAT/KgMS) and where a company is on the “value chain” (revenue/KgMS)

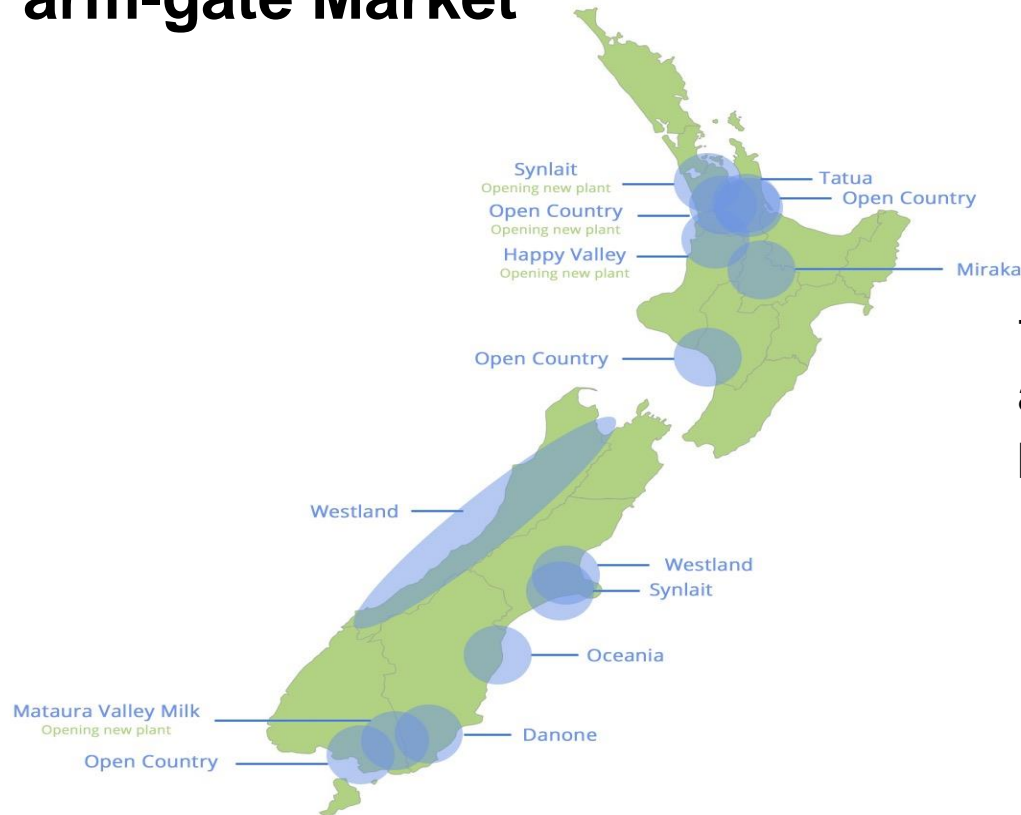
3. Is DIRA Still Needed?

DIRA Amendment Bill, 2019

- Proposed changes are at the margin
- Preserves open entry and open exit
- Detailed changes:
 - access to DIRA milk
 - dairy conversions
 - milk-price setting
- Reviews of DIRA every four to six years

3. Is DIRA Still Needed?

Farm-gate Market



74% of milk collected has access to more than one processor

3. Is DIRA Still Needed?

Farm-gate Market

Dairy Region	Total production (millions kgMS)	Percentage of national market (kgMS)	No. of processors
Waikato	503	27%	3
Whanganui / Manawatu	81	4%	2
Westland / Nelson / Tasman	85	5%	2
Canterbury	385	21%	4
Otago	101	5%	2
Southland	223	12%	3
Rest of NZ (5 regions)	483	26%	1

ComCom Part IV regulation typically applied where one supplier

3. Is DIRA Still Needed?

Domestic Dairy Products Market

- Under DIRA, Goodman Fielder has guaranteed access to 250M litres of raw milk p.a. at a regulated price
- The Commerce Commission has estimated that if the DIRA Regulations were removed, the domestic raw milk price would increase by around 25%
- Leading to an estimated:
 - transfer of wealth from New Zealand consumers to suppliers of \$51M to \$92M p.a.; and
 - an efficiency (deadweight) loss to the economy of around \$6M p.a.

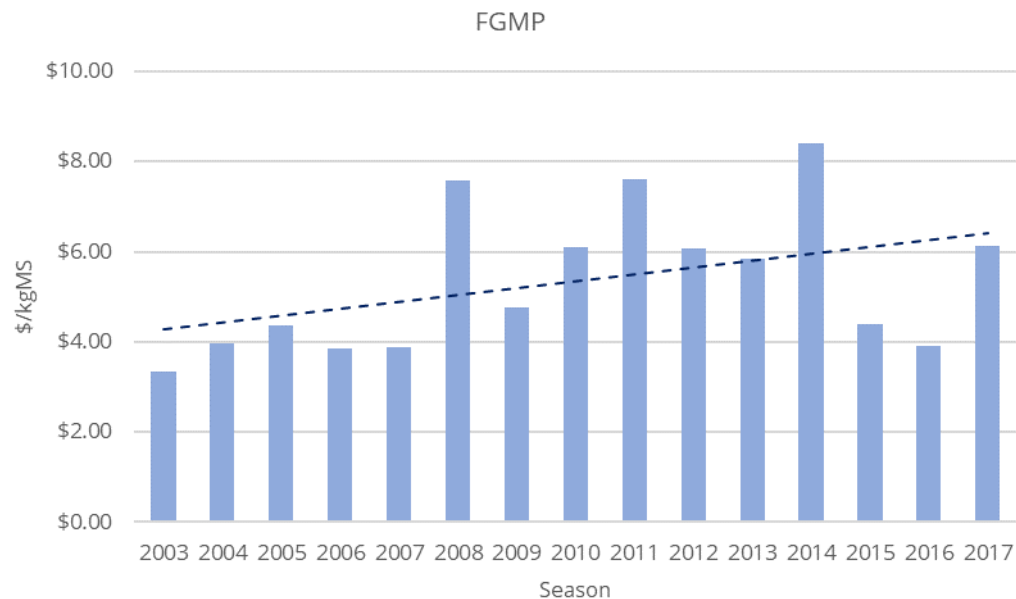
- Under DIRA:
 - The dairy sector overall has fared well; but
 - Fonterra has struggled
- With increased competition there are valid questions whether DIRA is still needed at the farmgate
- Given the domestic presence of Fonterra, regulation is still needed for the domestic dairy products market



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Over Paying for Milk?

- The Farm-Gate Milk Price shows a general increasing trend
- Fonterra's constitution states that it's goal is to maximise pay-out for milk to farmers, this has incentivised farmer volume production, requiring investment in processing capacity and not value add business



Over Investing in Processing?

- Fonterra has out-spent competitors



Debt to debt plus equity, 2018

