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Response to Fonterra and media comments on Castalia report

20 April 2022

Castalia prepared a report in February 2022 entitled *Implications of Fonterra's capital restructure* and published here. The report concluded that Fonterra's proposed capital restructure will significantly increase the number of farmer-only shares available to sell, while also reducing the number of buyers in the farmer-only market. This will lower the market price of the shares, have negative implications for competition in the dairy processing sector, with further detrimental implications for productivity and consumer prices.

In response to Castalia's report, Fonterra and media have focussed on the absolute value of Fonterra's farmer-only FCG shares and Fonterra Shareholders' Fund (FSF) units if the restructure proceeds. This fundamentally misses the key point of the Castalia report.

First, the restructure will have negative impacts on competition. Fonterra plays a dominant role in the milk processing sector, and its milk price effectively sets the default price floor for milk that the independent processors then must at least match. Fonterra is also a cooperative: owned by the suppliers of its costliest input. This means Fonterra has wide leeway to allocate its total return to its input costs (which is paid to its supplier-shareholders) or to dividends (also paid to supplier-shareholders).

It will always be quite difficult to ensure that a cooperative sets fair prices when competing with investor-owned (or Iwi trust-owned) milk processors. This difficulty was somewhat lessened due to market disciplines from FSF unitholders and FCG investors trading shares in a liquid market. The capital restructure removes these disciplines, and leaves the Fonterra Board with much more leeway to return capital to farmers through the milk price. The data and information set out in our report discusses Fonterra's track record in this regard. Based on sound logic and the information before us, we are convinced that the restructure will have a negative impact on competition and harm, rather than benefit, a vibrant dairy processing sector. It may also lead to higher consumer milk products.

Second, the exact valuation is very difficult to predict. Castalia's analysis shows how very powerful factors will depress the share price of the farmer-only FCG shares. Those powerful factors include:

- Potential sellers of dry shares will vastly outnumber the parties required to buy "wet" shares
- Most dairy farmers are cash constrained and will weigh up buying additional (illiquid) shares against other options to spend money such as repaying farm debt, improving

on-farm productivity (wage increases, additional feed and so on), meeting environmental and workplace compliance obligations, making capital investments on the farm or investing in other financial instruments. On balance, buying additional illiquid FCG shares will rank low

- The listed FSF will be capped, ending this option to crystallise value. We note the FCG shares dropped in price compared to FSF units immediately after the restructure announcement in May 2021 and remain at a $0.42 discount
- The restructure shifts the balance of incentives on Fonterra to return capital to its farmer-owners via the milk price payment, rather than via a dividend, which increases the riskiness of any dividend cashflows (and therefore changes the discount rate one should apply to any dividends).

The sum of these effects is that the market price of Fonterra shares on the farmer-only market is likely to fall relative to where it was prior to the restructure being announced. The price will tend toward a simple function of the expected cashflows only. The shares will essentially become illiquid financial investments, akin to a bond that is hard to sell.