FONTERRA’S CAPITAL STRUCTURE PROPOSAL: A LAWLINK PERSPECTIVE

Lawlink is a national network of leading New Zealand law firms that represents the full spectrum of New Zealand business, including farmer members of Fonterra. Due to its breadth of expertise and geographical spread, Lawlink is uniquely positioned to bring a range of perspectives to the Fonterra proposal. Lawlink has brought together a number of its top lawyers to provide their collective insights on Fonterra's proposed capital structure.

The proposal

Fonterra's much awaited proposed new capital structure was announced on Friday 18 September. The cornerstone of the proposal is that it will be farmer members that will be asked to fund additional capital to meet the funding needs of Fonterra for the next 5 years, and not external non-farmer member sources. While a public listing is off the table, trading of shares between farmer members in 2011 also forms part of the proposal.

This article focuses on the key issues for farmer members of the co-op.

How will the new structure affect farmers? How will farmers be able to fund the new dry shares? How will the new valuation model affect farmers?

Consultation process

The Board of Fonterra is embarking on a consultation process, including farmer meetings with Directors, with the aim of asking farmer members to vote on the proposal at the forthcoming 18 November annual meeting if there is sufficient support. The Shareholders’ Council has indicated its support, having helped develop the proposal.

In many ways, the direction is clear, but a lot of questions remain to be answered. The timetable is reasonably tight with less than two months for consultation.

A three stage proposal

To recap, there are **three** main steps to the new structure.

First, farmers will be able to hold shares up to the value of 120% of their recent or expected milk production for the season.

Profit will be paid on all shares, but the additional 20% or dry shares will not carry votes.

Share transactions during end of season will be at the new season price. This is to remove the current anomaly arising due to the difference between the end of season and new season share price.

Secondly, there will be a change to the fair value share valuation by the immediate freezing of the current level of $4.52 until the restricted market value matches this price and then the price will be free to move above or below the $4.52 value. This is to recognise that only farmers can own shares.

Thirdly, shares will be able to be traded among farmer members, rather than only dealing with Fonterra. This third aspect is seen as less of a priority and is targeted for consideration at the 2010 annual meeting and for implementation in 2011.

It is the first two steps Fonterra is expecting to put to its members at the November annual meeting for approval if there is enough support.

Rationale for the proposal

The proposed new structure recognises that Fonterra needs a stable funding base to achieve growth and greater returns to its members. That will come from farmers' equity, rather than outside equity or by increasing debt. By ruling out funding by non-members and signalling that debt reduction remains a priority, Fonterra is asking its members to provide additional funding. Fonterra conservatively expects this additional funding will meet its needs for about 5 years. The source of the additional funding will be by the issue of what are called dry shares to the value of 20% of the milk production. In other words, farmers will be given the option of contributing capital equal to one fifth of the value of the shares in Fonterra.

Fonterra has signalled that farmers may be allowed to buy shares and also dry shares mid-season, which become entitled to the full dividends for the current season. There may also be a requirement to hold new shares until the end of the next season (31 May 2011).

Implications

As a co-op, Fonterra can choose to have shareholders who are not members of the co-op. Despite fears to the contrary, Fonterra is able to restrict the overall level of non-member shareholding so that overall ***control*** remains with the farmer members. Fonterra has chosen not to permit non-member shareholders, removing the emotive issue of outside ***ownership*** altogether. However, as future options, Fonterra has indicated it might allow retiring farmers and pension funds to hold dry shares.

The step of changing the share pricing is necessary with the eventual move to free trading of the co-op's shares. This ensures a neater transition from the current model where the share price is somewhat artificial, is effectively discounted, and only used for limited purposes, to one where the price is simply the price at which buyers and sellers trade their shares.

Farmers are being asked to swap the existing model where redemptions due to lower milk production reduce the capital base of the company, but the personal interests of each farmer are preserved, for a model where the co-op has a much more stable capital base and it is the farmers who bear the effects of any change in the share price, as underpinned by milk production and price. Farmers will, once share trading is approved, be able to realise cash or increase their holdings by trading their dry shares.

Questions

If farmers haven't already asked these questions, they should raise them with Fonterra or at the annual meeting:

- If Fonterra's debt level is too high, what is the appropriate level of debt and equity for Fonterra?
- Has an international comparison been done and will this be made available to farmer members?
- Will this level change if the cost of debt falls and availability of debt increases?
- Does the Board have a 5 year plan for Fonterra if the additional equity is intended to meet Fonterra's funding needs for that period?
- Will Fonterra buy back shares if Fonterra has too much equity?
- How will dry shares be offered in the future- to holders of shares or to holders of dry shares?
- Does Fonterra realistically expect all farmers to take up their entitlements (given current farmer debt levels, farm expenses and production levels)?
- What will Fonterra do if the take-up is less than expected?
- Will farmers be able to take up their entitlement to dry shares in future years or is it a one-off limited offer?
- When will farmers be asked to pay for any new shares? Will payments be by instalments or a one-off payment?
- How will farmers be able to fund their allocation?
- Presumably, farmers will need to fund the dry shares from their own cash resources or borrow. Who is likely to lend the money and on what terms?
- Isn't this simply swapping Fonterra debt for farmer debt?
- Will borrowing to fund the dry shares be generally tax efficient for farmers?
- Will there be any maximum holding of dry shares once trading is permitted?
- Will share trading be on a recognised share trading platform?
- How will farmers determine the price they will be prepared to trade shares? Will Fonterra arrange for research analysts to provide regular reports?
- Will there be any trading restrictions on dry shares?
- If the dry shares are non-voting, will they be valued differently from voting shares?
- How will the gap between introducing new shares and trading among farmers (if approved) in 2011 affect the valuation model?

To discuss any aspect of this article, please contact the lawyer you usually deal with in your local Lawlink firm, or contact Lawlink's General Manager, Carol Patton at carol.patton@lawlink.co.nz or telephone (09) 300 5472.