Capital Structure Review FAQs

FAQ Overview

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General

1. **What does capital structure cover exactly?**

- Capital structure can be defined as the way a company manages the balance between its debt and equity to finance its activities, assets and growth.
- As a farmer-owned Co-operative, we think about other things as well, like: how should the price of our shares be set; how can we give farmers flexibility with their capital; to what extent should non-farmers be able to invest in the Co-operative; how much capital do we need to support our strategy; and more.

2. **Why is capital structure important?**

- Getting our capital structure right is important to helping ensure our financial sustainability.
- It supports our purpose, strategy, performance and ability to maintain farmer ownership and control over the long term.
- It plays an influential role in key areas of our business such as maintaining a strong balance sheet and enabling us to be resilient to shocks.
- It also directly impacts individual farming businesses – from how flexible farmers can be with their capital to how much they're getting as a return on investment, and much more.

3. **When did the capital structure review start and what is its objective?**

- The groundwork for our capital structure review was laid in late 2019, after our strategy refresh.
- Alongside the refreshed strategy, the Board has spent a significant amount of time reviewing our Co-operative's capital structure.
- The objective is to have a capital structure that helps ensure our financial sustainability well into the future so we can deliver value for this generation and the next.
- This has led the Board to focus on two main areas: maintaining a sustainable milk supply and protecting farmer ownership and control.

4. **When it comes to milk supply, isn't performance more influential than structure?**

- To a certain degree, strong performance does help us maintain a sustainable milk supply and we will continue to focus on performance.

- But if increased performance increases the share price, it becomes harder for new farmers to buy shares to join the Co-operative, and it can be a key factor for existing farmers in their decision to leave, so they can sell their shares and free up capital.
- See more about how we think our capital structure is tilting the playing field against us in Section 4 of the Consultation Booklet.

5. Why is farmer ownership and control so important?

- We inherited our Co-operative from generations of farmers before us who knew that they could achieve much more by working together, rather than working alone.
- The role of a co-operative is to give farmers control of their own destiny.
- Farmers know that our Co-operative will collect their milk and work hard to ensure they receive the best possible price for it. Maximising overall wealth of our shareholders is at the core of Fonterra's purpose.
- Having a strong farmer-owned co-operative in our dairy industry is important to every New Zealand dairy farmer, and for the country as a whole.
- Our milk price sets a benchmark in New Zealand, so even those who don't supply the Co-operative benefit from it.
- It's also clear from farmer feedback that ownership and control is their number one priority.
- See the inside cover of the Consultation Booklet for more details.

6. What stage is the review at?

- We are currently consulting with farmer owners on potential options to change our capital structure.
- Farmers have the chance to share their views through a series of meetings, webinars and other opportunities.
- No decisions have been made on changes, and we're taking the time needed to consult and consider farmer feedback before moving to the next stage.
- Further details on the milestones are included in Section 6 of the Consultation Booklet.

7. Why is the Board proposing potential changes?

- The review has highlighted that there are elements of our current structure that are challenging for a number of farmers now, or that may create challenges for our Co-operative in a flat or declining milk supply environment. These are explained in more detail on pages 4-5 and 22-23 of the Consultation Booklet.
- At a high level, the Board believes it's time to evolve the Co-operative's capital structure because:
  - The environment the Co-operative is operating in has changed, particularly around milk supply.
  - The level of investment to be part of the Co-operative is challenging for a number of farmers.
  - If we provide more flexibility for farmers the Fund size could grow significantly and, based on the scenarios included on page 22 of the Consultation Booklet, the thresholds that were put in place to help protect farmer ownership and control could be exceeded within the next few seasons.
  - The Fund size could also grow if milk supply declines.
  - To stay within the Fund size thresholds, our Co-operative would need to take action – such as buying back shares or units. Buy-backs create an uncertain demand on our capital, potentially impacting our ability to invest in strategy and growth. Conceivably, buy-backs could cost shareholders up to $1.2 billion over the next ten seasons. An alternative would be increasing the thresholds to allow a greater degree of external investment. The Board doesn't think either of these are ideal outcomes.
- We've evolved our structure before, and it's important we keep evolving it as things change.
- Exactly how our capital structure evolves is what we are consulting with farmers on.

8. Why now?

- We appreciate that there is a real sense of optimism in the Co-operative with our improving financial performance. But the issues raised through this review need to be addressed early.
- Acting now gives farmers more choice. For example, at the current share price and Fund size, our farmers have the ability to make a decision about the future of the Fund. If the Fund size grows, then this may no longer be an option for the Co-operative.

- Acting now also means we can better consult with farmers.

9. The Co-operative has been selling a number of assets and has a stronger balance sheet – therefore what is wrong with buy-backs in the future?

- Buying back shares or units is one potential option to stay within the constitutional thresholds if milk supply declines to the extent suggested by the scenarios included in the Consultation Booklet.
- While it could potentially be accommodated, it would put an uncertain demand on our capital in the future and potentially impact our ability to invest in strategy and growth.
- And, buy-backs don't address the lack of flexibility for farmers that our current structure creates.
- It is also worth noting the other impacts that come along with declining milk. This could include the potential for reduced scale efficiencies across milk collection and manufacturing operations or an ongoing requirement to continually right-size our operations.

10. What are the potential options for change?

- The Board has spent a significant amount of time looking at a wide range of options, including staying with the current structure. Some of the alternative structures considered include:
    - dual share structures, which would move from the current single Co-operative share to a compulsory supply share and a separate non-compulsory investment share
    - unshared supply structures
    - a traditional nominal share structure
    - a split co-operative model
- All options are explained in the Consultation Booklet, which has been sent to all Fonterra farmers.
- After its analysis to date, and to help give the conversations with farmers some structure, the Board has shared a preferred option – "Reduced Share Standard with either No Fund or a Capped Fund".
- This indicates current thinking, but the Board remains open minded about adjusting that direction based on farmers feedback.

The consultation process and associated temporary measures

11. How can farmers have their say and when do they need to do this by?

- There are multiple ways farmers can share their views.
- One of the options is via the online form at Fonterra.com/csfeedback.
- Other channels include face-to-face farmer meetings or webinars (schedule available here) or by contacting their Director, Area Manager or the service team on 0800 656568 or emailing us at csfeedback@fonterra.com. All the details are provided in Section 6 of the Consultation Booklet.
- We're looking to gain as much feedback as possible by the end of June, as we intend to share initial farmer feedback in July.

12. What main areas are you looking for feedback on during consultation?

- The Board has outlined on page 9 of the Consultation Booklet its current thinking on how its preferred structure could work.
- This has been done after looking at different options for some of the features, such as the 1:4 share standard, the 4x cap on shares, associated voting rights and more.
- We are particularly keen to hear farmer views on these points over the course of the consultation process, as well as the key considerations outlined on pages 12-13.
- The Board is also open to feedback on any of the other options that have been considered.

13. What are the next steps and when is the review likely to conclude?

- Once we hear farmer views, and if the appetite for change remains, we would do further work to refine the preferred option(s) and have a second round of consultation.
- If the Board decides to seek a change to our capital structure, the likely aim is to hold a farmer vote around the time of the Annual Meeting in November. The approval of 75% of votes from voting farmers would be required.
- If the preferred outcome is to buy back the Fund, it would also require the approval of 75% of votes from voting unit holders.

- As some aspects of our current capital structure are reflected in DIRA, any vote is likely to be conditional on any necessary changes to legislation being passed.

14. Why was it necessary to temporarily cap the size of the Fund before starting consultation?

- This is not a decision we made lightly. It was clear from the outset that consultation for this review would be more challenging than last time because both shares and units in the Fund are traded securities and we need to comply with continuous disclosure rules.
- As we progressed the review and started looking into options that included buying back the Fund, we identified a risk that, if we started consulting on options for change without temporarily capping the Fund, the Fund size could have grown significantly and taken the option of buying back the Fund off the table before farmers had a chance to consider it.
- Some of the options have the potential to see differences emerge between the price at which a share trades in the FSM compared to what a unit in the Fund trades at, with units trading at a higher price than shares.
- If the temporary cap was not in place, anyone holding dry shares would be able to exchange them into units in the Fund. This could more than double the size of the Fund and make options that include buying back the Fund unaffordable in the context of our current balance sheet targets.
- The temporary cap was a necessary step to keep all of our options for change open while we have a free and frank conversation as owners.

15. How will the FSM and Fund work during the temporary cap?

- The temporary cap means that shares can no longer be exchanged into units. Farmers will be free to buy and sell shares in the FSM and anyone holding units in the Fund, which may include farmers, will be free to continue buying and selling units on the NZX or ASX.

16. What is likely to happen to the price of farmers' shares and unit holders' units during the consultation process when the temporary cap is in place?

- The prices for units in the Fund and shares in the FSM may not be as closely aligned as they have been to date.
- Even if a price difference does emerge, given that no additional shares have been issued, the Co-operative's value on a per share basis has not been diluted.
- It's important to note that pricing of shares under the temporary cap may not reflect pricing of shares in a farmer-only market during normal trading. In other words, what we see during this temporary cap might be different to what we could see if farmers decided to move to a structure with a farmer-only market.
- This is because share standard compliance obligations are on hold for farmers holding at least 1,000 shares during the temporary cap, so there may be lower levels of trading. Plus, because we are consulting on potential changes, there is a degree of uncertainty about our future capital structure.
- The market maker, or registered volume provider, that has been active in making bids and offers on a minimum number of shares in the FSM and the Fund since our current structure was implemented will continue to operate in the FSM during the temporary cap. However, the share price could move more on small volumes of trading.
- If the Board's preferred structure of a Reduced Share Standard with either No Fund or a Capped Fund were to be implemented, then the current uncertainty would no longer exist – some farmer owners would be required to trade shares to at least comply with the Reduced Share Standard and some farmer owners may choose to buy shares over and above their individual minimum requirements.
- See page 12 of the Consultation for further details on the impacts of a farmer-only market.

17. What does putting compliance obligations on hold during consultation mean for farmers?

- This means that all supplying farmers holding a minimum of 1,000 shares will not be required to buy or sell shares to meet the share standard for the 2021/22 season until a later date to be advised.
- Compliance obligations are also temporarily on hold for those farmers who have not yet met their Share Standard compliance obligations for the current 2020/21 season. This is so that no farmers are required to trade for compliance purposes during the temporary cap, until a date to be advised.

18. What about farmers on a Share-Up Over Time Contract?

- These farmers will also not be required to buy or sell shares to meet their relevant share up requirements for the 2021/22 season until a later date to be advised, as above.
- For farmers whose final year of their Share-Up Over Time contract is 2021/22, they can still submit a cease notice for the following 2022/23 season, even if they will not have fully shared up due to compliance obligations being on hold.

19. What happens to delegated compliance trading?

- With compliance obligations on hold for all farmers holding a minimum 1,000 shares, delegated compliance trading will not be offered for this season. If a date for compliance is advised in accordance with the above, then delegated compliance trading will likely be offered at that time.

20. If compliance obligations are on hold why have you set a Compliance Date of 20 April 2022?

- Our Constitution requires a Compliance Date to be set before the start of each season. The formal Compliance Date for the 2021/22 season has been set as 20 April 2022, which is consistent with previous seasons. However, as explained above, farmers holding a minimum of 1,000 shares will not be required to comply with the Share Standard until a date to be advised.

21. What does putting the purchase of units under the Contract Fee for Units Trust on hold during the consultation process mean for farmers?

- Under the Contract Fee for Units trust, the contract fee paid by a farmer under a Share-Up Over Time contract, or supplying MyMilk, is transferred to a trust and used to purchase units which are held on trust for the relevant farmer. Those units are then distributed to the farmer when the farmer needs to share-up under the contract, or for MyMilk suppliers, when they need to acquire shares to supply the Co-operative.
- The Contract Fee for Units Trust is a discretionary scheme we offer. The Trustee will continue to hold the 5c/kgMS contract fee on trust for the relevant farmers but given the consultation on capital structure changes, the Trustee will not apply that 5c/kgMS to purchase units to hold on trust for the relevant farmers.

22. What happens to the Contract Fee?

- The Contract Fee is set each season. It was set at 5c/kgMS for the current season and has also been set as 5c/kgMS for next season. It will continue to be deducted from milk payments for next season, and will be held on trust under the Contract Fee for Units Trust. However the purchase of units by the Trustee has been put on hold until a date to be advised by the Board.

23. How open is the Board to changing its preferred direction of travel based on feedback received during consultation?

- The preferred option indicates current thinking, but we are open minded about adjusting that direction based on farmer feedback on all of the options.

24. What will you do if this goes to a farmer vote in November but it is not passed?

- We have no preconceived outcome and it may be that this review results in no changes.
- No decisions have been made on any change, and we are taking the time we need to consult with farmer owners and consider feedback before moving to the next stage.

How the review has been conducted and findings to date

25. What has the review involved to date?

- The Board started by identifying what the key elements of a financially sustainable Co-operative are and developing a set of design principles. These were shared externally after our annual results in September 2020 and are included in Section 4 of the Consultation Booklet.
- The wide range of alternatives were assessed and prioritised based on how well they met the objectives of the review and the design principles.

26. How were farmer views taken onboard?

- While we would have liked to have been out on the road discussing options with farmers earlier, we have gained useful insights from farmer workshops on capital flexibility that were held in 2019, the roadshows after annual results and interim results, a phone survey we did in December 2020 of a representative sample of 350 farmer owners, as well as the online survey available to all farmers from January to February 2021 where we had around 1,800 responses.

27. What views did farmers express before the consultation process kicked off?

- The online survey results confirmed that there is an appetite for change, with 62% of respondents either strongly or slightly supporting a change.
- The results also gave us an insight into what farmers consider are the main priorities in any potential structure. These are outlined in Section 4 of the Consultation Booklet.

28. What were the findings to date?

- The review has highlighted that there are elements of our current structure that are challenging for a number of farmers now, or that may create challenges for our Co-operative in a flat or declining milk supply environment.
- These are explained in more detail on pages 4-5 and 22-23 of the Consultation Booklet.

The preferred option

29. Why has the Board decided to put forward a preferred option?

- After its analysis to date, and to help give conversations with farmers some structure, the Board has put forward a preferred option – a "Reduced Share Standard with either No Fund or a Capped Fund".
- The Board arrived at this point after reviewing a wide range of capital structure options from co-operatives around the world – both within and outside the dairy sector – as well as options to evolve our current structure.
- This indicates their current thinking, but the Board is open minded about adjusting that direction based on farmer feedback on all of the options.

30. What are the key benefits and trade-offs of this option?

- Based on the work to date, the Board believes the preferred option would help us address the challenges we face today and those we are likely to face in the future, better enable the delivery of our refreshed strategy and help us build a more financially sustainable Co-operative.
- It would give farmers more flexibility, while ensuring farmer ownership and control is protected.
- A key outcome of this change is that shares would be bought and sold between farmers in a farmer-only market. We want to be clear that we expect this change to impact the price at which shares in the Co-operative are traded, and that there may not be as much liquidity in the market.
- Ultimately, the price of our shares would be determined by the performance of our Co-operative and trading between farmers.
- Currently our share price moves in line with the price of units in the Fund. In that sense it is influenced by unit holders, who have a different investor profile to that of us farmers – a farmer's cost of capital is typically higher.
- To cater for share flexibility, some farmers would inevitably have more shares than others. We believe this is a more sustainable proposition over the longer term than the alternatives we are confronted with.
- See Section 3 of the Consultation Booklet for more information on the preferred option.

31. The Co-operative already has tools like MyMilk and Share-Up Over Time Contracts – don't these provide enough flexibility for farmers?

- These options provide support for new farmers joining the Co-operative, but they do not provide flexibility for existing farmers. We know that the high compulsory cost of investment is a key factor in farmers' decisions to leave.

32. What would the main differences be between No Fund and a Capped Fund?

- Removing the Fund would involve an offer by Fonterra to unit holders to buy back their units at a fixed price. The approval of at least 75% of unit holders entitled to vote and voting would be needed for the offer to be accepted. The offer amount would need to be acceptable to unit holders, fair to farmers and would need to make more sense to the Co-operative than the Capped Fund alternative.
- A Capped Fund would involve the Fund remaining part of Fonterra's capital structure and listed on the NZX/ASX, but with one key change in that farmer owners would no longer be able to sell any further economic rights of shares into the Fund. Shares would be tradeable in the FSM only.
- Members of the public could continue to trade units in the NZX/ASX, with units continuing to receive distributions in line with our performance. Farmer owners would also still be able to exchange any units they hold for shares in the FSM.
- It would mean that the size of the Fund as a proportion of our Co-operative could not increase materially, but it could decrease if farmer owners exchange units they buy or hold into shares. Fonterra could also potentially buy it back in the future – partially or fully.
- See page 8 of the Consultation Booklet for more details.

33. Does the Board have a preference for No Fund or a Capped Fund? If so, why?

- We have reached a preliminary view that having No Fund would be preferable to a Capped Fund because it simplifies our Co-operative.
- However, if we cannot reach an acceptable arrangement to buy back the Fund that 75% of voting unit holders support, then a Capped Fund would also work.
- In other words, we would only seek to remove the Fund at a reasonable price that was acceptable to unit holders, fair to farmer owners and made sense to the Co-operative compared to the Capped Fund alternative.

34. Why is the preferred option considered better than the Co-operative's current structure and other potential alternatives?

- The Board prefers the Reduced Share Standard structure over the other options, including staying with our current structure, for several reasons.
- Overall, we think this structure measures well against the design principles for the review while remaining aligned with our Co-operative Principles.
- It provides greater flexibility for farmers, which we think will better support a sustainable milk supply for Fonterra so that we can continue to operate efficiently.
- It also helps protect farmer ownership and control, which in turn protects our interests as suppliers.
- It still requires all suppliers to become farmer owners with capital-backed supply, and all farmer owners would still have exposure to both milk price and some earnings.
- It is preferable to a Dual Share structure at maintaining a strong balance sheet for our Co-operative. This is a high priority for us and was also reflected in farmer feedback. This is because retaining a single share would mean that all share capital is rated as equity (which would not be the case under a Dual Share structure where one of the shares may be partially classified as debt by ratings agencies).
- We also think it would be more straight forward to implement than other options.
- No structure is perfect. All options involve trade-offs. What we're not willing to trade off is farmer ownership and control that protects overall returns – including milk price and dividends.
- While we know that moving to a farmer-only market may have implications for the price of farmers' shares, we believe maintaining farmer ownership and control of the Co-operative is worth this trade-off.

35. How might the preferred option better support the delivery of the Co-operative's strategy?

- New Zealand milk is at the heart of our strategy – everything starts there. We need a sustainable milk supply in order to execute our strategy.
- We believe that the Reduced Share Standard with No Fund or Capped Fund would create greater flexibility for farmers to better support a sustainable milk supply for the Co-operative.
- It also protects farmer ownership and control, including the maximum sustainable milk price for farmers over the long term.

- If we stay with our current structure and milk supply declines to the extent suggested by the scenarios included on page 22 of the Consultation Booklet, then the actions we would expect to have to make – such as continually funding buy-backs – would mean that resources would not be entirely focussed on delivering our strategy.

36. How much would it cost to buy back the Fund?

- The exact cost is uncertain at this stage but capping the Fund size removes the risk that the Fund size grows and significantly increases the total cost.
- We would need to reach an acceptable arrangement that 75% of voting unitholders support.
- We would only seek to remove the Fund at a reasonable price that was both acceptable to unitholders and fair to farmer owners.
- We would view a buy back more as an investment than a cost.

37. Could the preferred option potentially result in too much concentration in ownership?

- The Reduced Share Standard structure, with the minimum requirement set at 1:4, is intended to provide meaningful flexibility for farmers to reduce their shareholding while ensuring there is sufficient ability for other farmers to hold a greater number of shares without giving rise to a significant concentration of ownership.
- A different ratio of say 1:10 that allowed farmers to lower their share ownership even further would mean the 4x cap would need to be higher so that there would be enough buyers in the farmer-only market. This could potentially give rise to too much concentration in ownership with a small group of farmers.
- When it comes to voting rights and the potential for concentration of ownership, it’s important to note that because voting rights would be “per 1,000 kgMS backed by shares”, a farmer who continues to hold shares on a 1:1 basis relative to their supply in the previous season will retain the same voting entitlement as today, and a farmer who holds additional shares over the 1:1 basis (up to the maximum shares at 4x kgMS supplied) would only have voting rights up to the 1:1 level, not their full shareholding.
- During consultation, we welcome farmer views on whether there should be any other mechanisms to support greater alignment between farmers.

38. What would happen to MyMilk and Share-Up Over Time contracts?

- Share-Up Over Time and MyMilk contract supply options would be phased out (although all existing commitments would be honoured).

The other options

39. Couldn’t the Co-operative stay with the current structure and buy back shares or units in the future if milk supply declines?

- Buying back shares or units is one potential option to stay within the constitutional thresholds if milk supply declines to the extent suggested by the scenarios in the Consultation Booklet.
- While it could potentially be accommodated, it would put an uncertain demand on our capital in the future and potentially impact our ability to invest in strategy and growth.
- And, buy backs don’t address the lack of flexibility for farmers that our current structure creates.
- It is also worth noting the other impacts that come along with declining milk. This could include the potential for reduced scale efficiencies across milk collection and manufacturing operations or an ongoing requirement to continually right-size our operations.

40. What would the Dual Share option with either No Fund or a Capped Fund look like?

- This involves moving away from our current single Co-operative share to a structure with two classes of shares – a compulsory supply share and a separate non-compulsory investment share.
- As with the Reduced Share Standard structure, the Dual Share option would give more flexibility to farmers but also has the potential for the existing constitutional thresholds to be exceeded if we took no action in relation to the Fund, as the investment shares could move into the Fund over time.
- That’s why we would need to either buy back the Fund or cap the size of the Fund.
- See Section 5 of the Consultation Booklet for more details.

41. What are the key benefits and trade-offs of this option?

- This option gives farmers the ability to choose whether or not to invest in the Co-operative beyond milk supply and the associated compulsory supply shares.
- Because the supply share would carry a nominal price, this price would not fluctuate over time. This means that those farmer owners that choose to hold only supply shares would not carry any risk of movements in the Co-operative share price over time.
- Farmer owners would not be required to hold any investment shares and could therefore choose to remove most of their exposure to earnings performance.
- Features such as the nominal value for the supply share and the cap on investment shares could be changed over time. In addition, the dividend on supply shares, voting rights and the time frames for sharing up and selling shares on exit could be set differently.
- The impacts of a farmer-only market outlined on page 12 of the Consultation Booklet under the Reduced Share Standard structure would also apply to this Dual Share option.

42. Why did this option not end up being the preferred one?

- The key reasons why this is not our preferred option are:
  - The supply share is likely to be treated as a half debt and half equity ("hybrid") instrument by the rating agencies that review Fonterra's financial strength, and as debt for accounting purposes. This means that it would reduce the Co-operative's balance sheet capacity by around $750 million (or potentially $1.5 billion if it is rated as all debt), which could limit our financial flexibility over time.
  - A Dual Share structure could result in less alignment among the Co-operative's farmer owners than a Reduced Share Standard structure. Farmer owners that choose to only hold supply shares may be more interested in investment in activities that are milk price focussed with less interest in value-adding strategies and investments. On the other hand, those farmer owners with a large proportion of investment shares may be more aligned with business decisions that drive earnings.
  - As there would be no requirement for farmer owners to hold investment shares, there may be less liquidity in farmer-only market than under a Reduced Share Standard.
  - A Dual Share structure is likely to be more complex to transition to and operate over time.

43. What other options has the Board considered?

- Some of the other options that were considered earlier in the review include unshared supply options, traditional 'nominal share' options or options that split the Co-operative.
- These are explained in more detail on pages 28-29 of the Consultation Booklet.

44. Why did those other options not get prioritised?

- Farmer views helped narrow down the options. The Board prioritised two they thought could best meet the objectives of the review for a closer analysis. That closer analysis resulted in the Board putting forward a preferred option.