Feedback on MPI’s Terms of Reference for

REVIEW OF THE DAIRY INDUSTRY RESTRUCTURING ACT 2001 AND ITS IMPACT ON THE DAIRY INDUSTRY

July, 2018

mataura VALLEY MILK

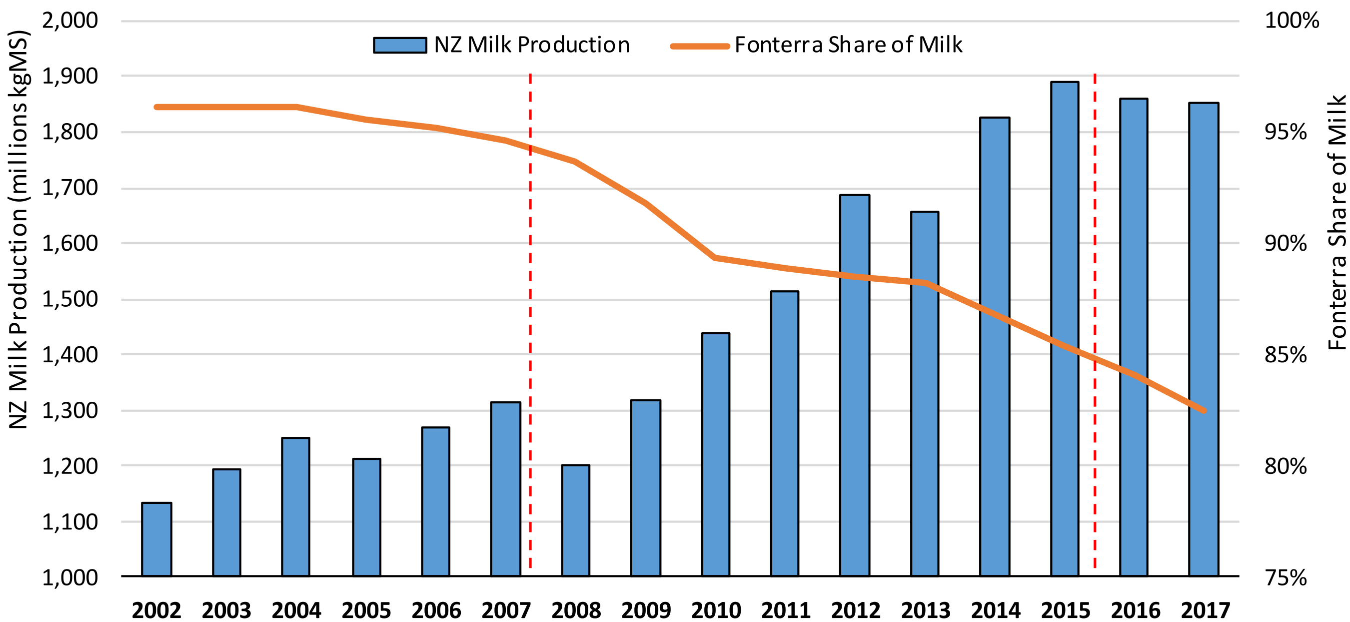
This report was used as an oral presentation and it is not a complete record of the discussion.

Executive Summary

- The New Zealand dairy industry is entering its third phase
- Competition has delivered demonstrable benefits to NZ
- Farm-gate contestability is essential to fair competition
- This has also been enabled by the regulated availability of raw milk to new processors
- Changes in share of milk supply are closely aligned to farm-gate milk prices and company performance
- MVM aspirations are aligned to high value production and processing, and delivering significant benefits to Southland
- Regulation must remain focussed on contestability

The dairy industry is entering its third phase

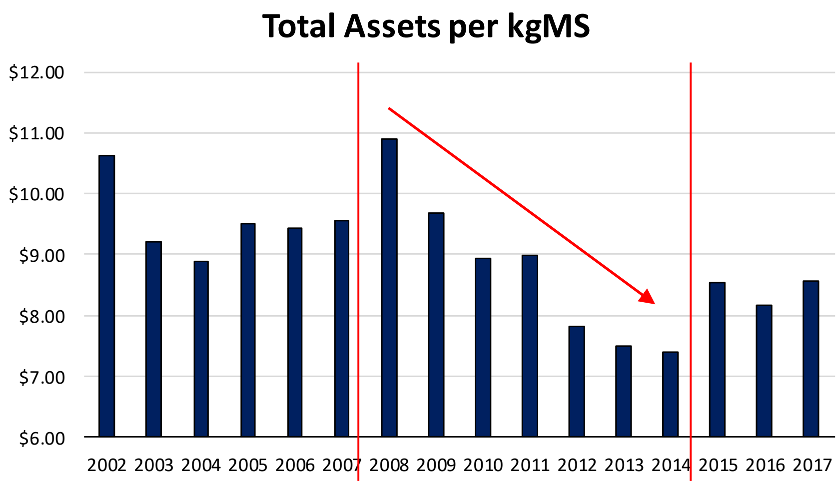
NZ Milk Production and Fonterra Share of Milk 2002 - 2017

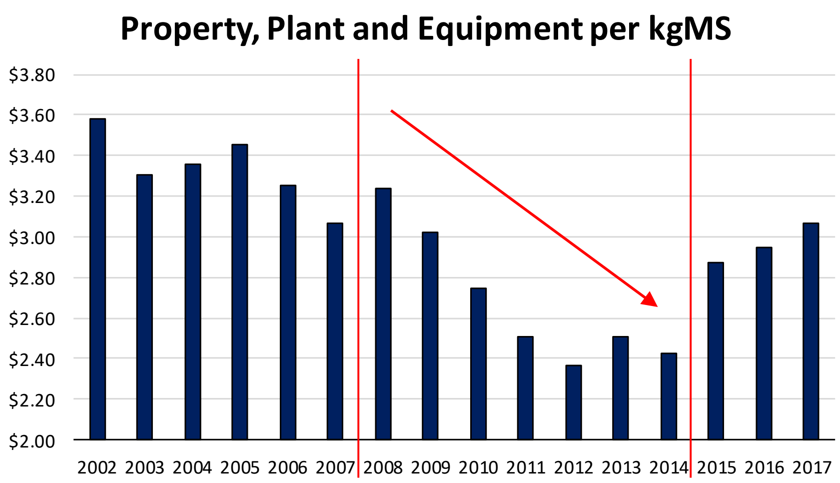


Phase 1 2001 - 2007	Phase 2 2007 - 2015	Phase 3 2015 -
Strong Milk Growth Little farm-gate competition	Very Strong Milk Growth Increasing farm-gate competition	No Growth Intense competition

Competition delivers demonstrable benefits

Fonterra Efficiency Metrics





Source: Fonterra Annual Reports

2001 – 2007:

- No real competition (milk share dropped 96% to 95%)
- No significant efficiency gains

2007 – 2014:

- Farm-gate competition
- Significant efficiency gains
  - Restructure of Fonterra NZ manufacturing
  - Launch of globalDairyTrade, and downsizing of global sales team

2015 - :

- New capital build program to add extra capacity for manufacturing flexibility, and also develop capacity in new products
- Acquisition of large share in BeingMate

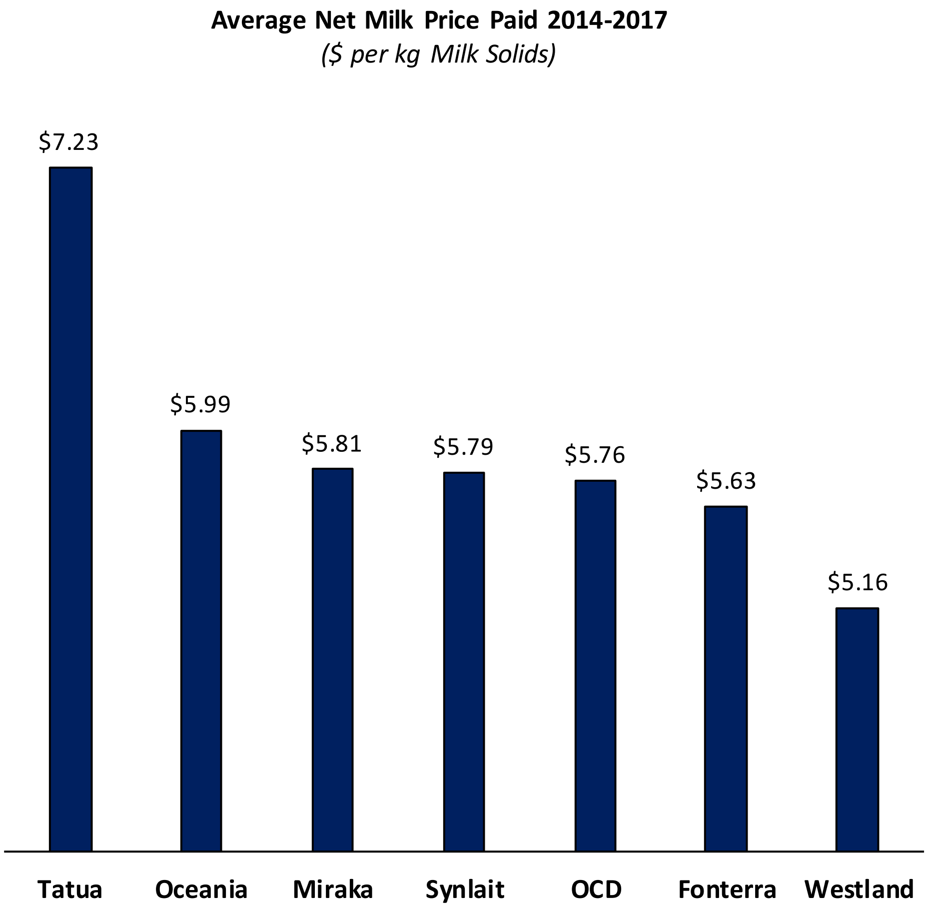
Farm-gate contestability is essential to fair competition

- The free-entry-and-exit regime ensures milk is contestable at the farm gate
- In absence of DIRA, milk would be tied up in long-term contracts before new dairy companies could establish
- If either the "free exit" or "free entry" conditions are removed, the whole market contestability is compromised
  - No "free exit" would lead to "handcuffs"
  - No "free entry" would make farmers reluctant to leave in the first place
- *Complaints of resulting problems with "uneconomic milk" and "stranded assets" do not apply in this third phase. They only occur for companies who don't pay enough at the farm gate!*

Availability of raw milk to new processors is key

- Starting a new dairy company is risky, and MVM is no exception to this
- DIRA regulations providing 50 million litres p.a. for three years at a regulated price greatly influenced MVM’s start-up
- 50 million litres is still not enough to operate at economic scale, but it does provide a starting point to build supply
- Removing availability of regulated raw milk would create a high hurdle for any future start-ups

Share of milk supply follows farm-gate milk prices



- Oceania, Miraka, Synlait and Open Country have all paid more for milk than Fonterra, and have grown their share of supply accordingly
- Tatua leads milk payments, but chooses to purchase from other dairy companies rather than expand its own supply base
- Fonterra and Westland have lowest average farm-gate milk prices
- Fonterra and Westland also have lower NZ milk collections in 2017 versus 2016
- Payment at the farm gate correlates strongly to business strategy and business performance

Note: Net Milk Price is calculated as milk price plus dividends, less retentions and share financing costs

MVM is a high value company paying a high milk price

- Infant Formula in consumer packaged format
- Strong in-market relationships and distribution channels
- High value placed on provenance of MVM milk
  – Incentive program for farm performance outcomes
  – Value on provenance above commodity
  – Aiming to de-link pricing from commodity

- Benefits to Southland region estimated at $90 million

MVM is a high value company paying a high milk price

Comparable Returns Analysis

The annual return to a notional farmer supplying 100,000 KgMS per annum before expenses and other revenue is estimated to be $694,000 for an MVM farmer compared to $654,000 for a Fonterra farmer. There is also material upside to MVM's returns in terms of dividends and capital appreciation.

- The table opposite summarises a comparable returns analysis between MVM and Fonterra taking into account different milk price, dividend and supplier share assumptions.
- The analysis is based on a notional farmer supplying 100,000 KgMS per annum.
- The base milk price is assumed to be $6.50 per KgMS for both MVM and Fonterra. MVM is assumed to pay a supplier premium of $0.20 per KgMS, seasonal incentives of $0.105 per KgMS and quality incentives of $0.25 per KgMS. Fonterra is assumed to pay no seasonal incentives with capacity adjustments embedded into the base milk price.
- Fonterra is assumed to pay a dividend of $0.40 per KgMS based on recent dividend payments. MVM is assumed to pay no dividends, however this represents a material upside, especially after the first few years of operations (both in terms of dividends and capital appreciation).
- It is assumed that MVM supplier shares will cost $2.15 per KgMS based on analysis undertaken by MVM management. Fonterra supplier shares are assumed to have a cost of $6.50 per KgMS.
- The cost of capital on supplier shares is assumed to be 5.5% based on a notional bank borrowing cost.
- The analysis highlights that the annual return to a notional MVM farmer is $694,000 ($6.94 per KgMS) compared to $654,000 ($6.54 per KgMS) for a Fonterra farmer (before expenses and other revenue).

Comparable Returns Analysis

$ / KgMS	MVM	Fonterra	Variance
Key assumptions:			
Milk production (KgMS 000)	100	100	-
Milk price:			
Base milk price	6.50	6.50	-
MVM supplier premium	0.20	-	0.20
Seasonal incentives	0.11	-	0.11
Quality incentives	0.25	-	0.25
Total	**7.06**	**6.50**	**0.56**
Dividend	-	0.40	(0.40)
Capital assumptions:			
Cost of supplier shares	2.15	6.50	(4.35)
Cost of capital %	5.5%	5.5%	0.0%
Return analysis ($000):			
Milk revenue	706	650	56
Dividend	-	40	(40)
Cost of capital on supplier shares	(12)	(36)	24
Total annual return	**694**	**654**	**39**
Return analysis ($ / KgMS):			
Milk revenue	7.06	6.50	0.56
Dividend	-	0.40	(0.40)
Cost of capital on supplier shares	(0.12)	(0.36)	0.24
Total annual return	**6.94**	**6.54**	**0.39**

Regulation must remain focussed on contestability

- DIRA is NOT the right tool to manage environmental, animal welfare, farm workplace or any ‘external’ outcomes
  - e.g. Mackenzie Country is a Regional Council issue
- Environmental, animal welfare and farm workplace outcomes are important to the <u>provenance value</u> of dairy
  - MVM recognises this in its payment program
- Fonterra has its own internal issues that <u>it should manage itself</u>
  - e.g. tensions around fairness of collection costs
  - e.g. tensions created between different types of investor