A novel structure to participate in Fonterra's growth but pricing uncertainty prompts us to remain on the sidelines.

Fonterra Shareholders' Fund Pre-IPO Report

Recommendation: **Do Not Subscribe**

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Investment Perspective

The Fonterra Shareholders' Fund provides individual investors an opportunity to participate in Fonterra's performance through dividends and unit price appreciation. Being a significant exporter of milk and milk products, Fonterra's fortunes are inextricably linked to growth in dairy consumption particularly in Asia and Latin America. However we believe the company does not have an economic moat as it generates low returns on capital. We mainly attribute this to the commodity nature of its business. The higher margin branded goods category accounting for 35–40% of earnings offers the potential to lift returns but the presence of established multinational players like Nestle and Danone makes this task challenging. Our fair value of NZD 5.50 per unit is at the top end of the indicative offer price of NZD4.60–NZD5.50 per unit and equates to a gross dividend yield of 5.8%. However there is pricing uncertainty stemming from the large variance in the offer price (of nearly 19%) and the small possibility that Fonterra could price the offer above the suggested price band. Given these concerns and the limited scope for price appreciation at the top end of the offer price we would wait for the units to list on the market. Based on our valuation the units look attractive at a price below $4.95.

Business Overview and Risks

Fonterra is a leading integrated processor and marketer of dairy nutrition to customers worldwide. The company conducts its operations in two complimentary business segments a) NZ Milk Products and b) Regional Businesses

NZ milk products comprises 50% of Fonterra's operating earnings. The division collects and processes milk from New Zealand (NZ) farmers and manufactures and markets dairy nutrition products including dried powders, various food ingredients, butter and cheese, to global customers. Around 3% of milk collected is sold as fresh milk to the NZ grocery and retail market. In the 2011/2012 season Fonterra collected 17 billion litres of milk in NZ or approximately 89% of the national production. Customers include the world's largest infant formula manufacturers and the largest food companies. The cost of purchasing milk from farmer shareholders (estimated to be over NZD 9 billion in 2012) is Fonterra's single largest cost. Each season Fonterra sets the Farmgate Milk Price (FMG), which is the price it pays farmers. This is based on a referenced price for five select dairy commodities (also known as Global dairy trade or GDT) less Fonterra's cash and capital costs required to process the milk. Fonterra is able to achieve higher margins through management of product mix and obtaining prices above GDT.

The regional businesses segment provides branded consumer dairy nutrition products and out-of-home food services to markets in New Zealand, Australia, Asia, the Middle East & North Africa (AME) and Latin America. ANZ is the largest division comprising 20% of Fonterra's operating earnings. Apart from selling branded consumer products, the ANZ business also collects and processes approximately 18% of Australia's milk production. In Latin America – 12% of earnings – Fonterra owns Chile's largest dairy company Soprole (with an estimated market share of 30%) and owns 50% of Dairy Partners America with Nestle being the other JV partner. In Asia/AME – 19% of earnings – Fonterra's business revolves around four key brands Anchor, Fernleaf, Anlene, Anmum. These make up two thirds of Asia/AME revenues. The most significant growth market for out-of-home foodservice has been China where Fonterra has established a business with significant positions in core bakery categories.

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Fonterra's main risks stem from the movement in global dairy prices, exchange rates and the supply of milk in New Zealand. A rapid rise in dairy prices could undermine margins on consumer branded and out-of-home food service products. Also Fonterra's margins will be impacted if the price of dairy nutrition products (accounting for 20–25% of NZ Milk Products revenue) is less than the FMG. Fonterra is also exposed to foreign exchange risk since its revenue is derived globally. Fluctuations in the NZD versus other currencies could therefore undermine earnings. Fonterra collects approximately 89% of New Zealand's total milk supply which is processed into commodities such as whole milk and skim milk powder and sold globally. This overreliance on New Zealand's milk supply exposes the firm to supply risks. For instance farmers might choose to move away from dairy farming into other farming activities should they deem dairy farming to be less lucrative. Also Fonterra is required to collect all the milk produced by farmer shareholders rendering the company with excess production capacity during periods of weak demand and/or unfavourable dairy prices.

Economic Moat

We don't believe Fonterra possess an economic moat. While the company is the world's largest exporter of dairy products, its business is driven by commodity products like whole milk powder and skim milk powder which make up 60–65% of its operating earnings. Consequently the vast majority of the firm's business has no pricing power and generates mid-single digit operating margins. This pales in comparison to mid to high teens generated by some of the other multinational food companies. Fonterra aspires to sell more branded products to move up the value chain and boost returns. However we think it will face significant competition from companies like Nestle and Danone given their well entrenched positions in several key markets and geographies. A good example of this is ANZ where margins and earnings on branded products have taken a knock because of significant competitive pressures.

Table 1: Peer Group Comparison (using forward earnings estimates)

Name	Country	EV/EBITDA	PER	Div Yield %	Payout %	FCF yield %	ROIC
Fonterra*	New Zealand	7.7	12.7	5.8	75	7.6	9.0
Nestle	Switzerland	11.4	17.5	3.0	54	4.7	13.5
Dean Foods	USA	7.4	14.6	0.0	0.0	6.0	9.1
Danone	France	7.1	14.3	2.9	42	6.3	10.4
Pepsi	USA	9.6	15.8	3.2	50	6.1	15.7

Source: Fonterra Prospectus and Morningstar estimates

* based on price of $5.50 per share

Valuation and recommendation

Our fair value estimate is NZD5.50 per Fonterra Shareholders' Fund unit. This is based on our DCF valuation of the underlying Fonterra business assuming a weighted average cost of capital of 9%. This implies an FY13 PE of 12.5x, dividend yield of 5.8%, enterprise value/EBITDA of 8.3x and free cash flow yield of 6.9%. Fonterra will use the institutional book build process to determine the final price. Our main concern is that prospective investors won't know the price they are paying and quantity of shares they would be receiving until after the book build process is completed. As a result of this uncertainty, we would advocate investors wait for the units to list on the market and consider buying at a price below $4.95 per unit.

We have done a peer group comparison (illustrated in the table below) versus other listed multinational food companies. Overall, the company's valuation appears favourable using the top end of the offer price of NZD 5.50 per share. However, Fonterra generates lower returns compared to those companies and has a higher risk profile as the vast majority of its sales and earnings are linked to dairy prices which can be quite volatile. The branded products business generates 35–40% of its earnings but even here Fonterra hasn't been very successful in its key ANZ market evidenced by the significant decline in earnings over the last two years. Also, Fonterra relies on New Zealand farmers for 89% of its milk supply and therefore is vulnerable to supply shocks. Multinational food companies on the other hand have well diversified operations in relation to sales and raw material procurement. They also mainly sell branded products which enjoy better pricing power than commodity products. As a result we think the valuation discount is warranted.

In our earnings model we have assumed the company's revenues and earnings increase at a compound average growth rate of 5% and 6.5% respectively over the next five years reflecting worldwide growth in demand for dairy products. We have not assumed any price increases through this period given the difficulty in predicting dairy prices. Our operating margin assumption of 5.8% is consistent with prior periods.

Fonterra is expecting capital expenditure to rise significantly to NZD 1,138 million in FY13 compared to its three year historical average of NZD 657 million as it is undertaking capacity enhancements in New Zealand and China during the year. We expect capital expenditure to revert to normal levels of 4.2% of sales in the following years compared to 5.7% of sales in FY13. Working capital is expected to decline by 9% in

Table 2: Important Dates

Event	Date
Broker firm offer	5 November 2012
Broker firm offer closing date	21 November 2012
Institutional offer and book build	26–27 November 2012
Pricing and allocation announcements	27 November 2012
Allotments and expected commencement of trading on NZX	30 November 2012
Expected commencement of trading on ASX	5 December 2012

Source: Fonterra Prospectus and Morningstar estimates

Table 3: Key Information

	FY10	FY11	FY12	FY13E	FY14E
NPAT	685	771	624	690	741
EPS	51	55	42	43	47
Growth %	8	-24	2	9	
DPS	27	30	32	32	35
Yield %*	–	–	–	5.8	6.4
PE*	–	–	–	12.7	11.7

Source: Fonterra Prospectus and Morningstar estimates
* Based on $5.50 offer price

FY13 from elevated levels in FY12. Over the next five years we have assumed inventory and receivables to be around 25% of sales or in line with historical levels.

Difference between Fonterra Shareholder's Fund and direct share investment

Fonterra Shareholders' Fund is a unit trust established as part of Fonterra's Trading Among Farmers (TAF) scheme. It is meant for outside investors (investors other than farmers) who are not allowed to hold shares in Fonterra, which is a co-operative. Fonterra Shareholders' Fund will give unit holders the rights to receive dividends and other economic benefits derived from a share. However these rights do not include the rights to hold legal title to the share or to exercise voting rights in Fonterra. In essence individual/ institutional investors, without having direct ownership in the company, will be able to derive economic benefits from their indirect investment in Fonterra. The units will be listed on the NZX and ASX and can be freely bought and sold like any other listed security. It will represent 6-7% of the total number of Fonterra shares on issue. Fonterra Shareholders' Fund will appoint a manager to oversee the fund and a trustee for the benefit of unit holders.

A separate Trading Among Farmers market will exist alongside the Fonterra Shareholders' Fund. This will allow farmers, who are essentially Fonterra's shareholders, to trade shares between themselves instead of Fonterra having to repurchase/issue shares to farmers. The prevailing policy of redeeming shares exposes the company to the risk of paying large sums of money to farmers who stop or reduce their supply of milk to Fonterra. TAF removes this risk and provides Fonterra with a stable capital base. Farmers can also participate in the Fonterra Shareholders' Fund by exchanging shares for units and vice versa. In essence, Fonterra Shareholders' Fund will provide additional liquidity to farmers for their shares. However unit holders will not be allowed to exchange units for shares and will be restricted to the Fonterra Shareholders' Fund.

Risks pertaining to the new structure

The Fonterra Shareholders' Fund and its relationship with the Fonterra shareholder market is novel. The structure is untested and there is some uncertainty about how it will perform.

If the structure is unsuccessful, Fonterra retains the unilateral right to terminate the fund within two years after the launch date. In that event the fund will be wound up if all the economic rights held for the fund are acquired by Fonterra

The fund structure has been designed with the intention that shares and units should trade at very similar prices. There is no guarantee that this will be achieved or if achieved how long it will take or whether it will be maintained. Better liquidity will enhance share and unit price convergence.

The funds' or Fonterra's ongoing disclosure to investors and the financial community might be poor. This could have a detrimental affect on Fonterra's valuation and unit prices.

Offer price and allotment to investors

The final unit price will be determined by Fonterra through a book build process on 27 November 2012. This will involve institutional investors submitting bids for units. Fonterra has set an indicative price range of NZD4.60-5.50 per unit. However the company has the discretion to price the IPO above that range. Units will be allocated to individual and institutional investors based on the final price of the offer. Pricing will be announced on 27 November 2012 and the units will be listed on the NZX and ASX on 30 November 2012 and 5 Dec 2012 respectively.