



# An update from your Council

October 2023

## Representing Fonterra farmers

Key activities representing your interests since our [June update](#):

*You can find more detail on the following pages*



**Passing member feedback to the Board** including:

- farmgate milk price range forecasting, and on-farm profitability and cashflow concerns arising from the current forecast ranges
- concerns relating to the recent Farm Source team changes
- concerns around the impacts of this year's extraordinary adverse weather events on Co-operative Difference achievement
- questions around the announcement to target cost reductions across the Co-op by about \$1 billion over the 7 years to 2030
- questions on the rationale behind the decision to suspend minor Fat Evaluation Index (FEI) downgrades
- organic supplier concerns, and
- setting a Scope 3 target.

**Delivering the 2023 Letter of Members' Expectations to the Board**

**Asking the Board:**

- to provide an update on the expected timing of announcing the Scope 3 target (Management subsequently advising this will be towards the end of this calendar year)
- to report on the alignment between milk supply and ownership, and on the distribution of ownership of the Co-operative, as required by flexible shareholding policy (subsequently included in the 2023 Business Performance Report), and
- to engage with Fonterra farmers when taking advocacy positions on matters that may impact 'behind the farm gate'.

**Requesting from Management** its measures for assessing the effectiveness of the recent Farm Source structure changes.

**Questioning Board and Management on the FY23 results**

**Meeting with the auditor to discuss their FY23 audit engagements**

**Meeting with the Milk Price Panel to discuss the finalisation of the 2022/23 season farmgate milk price and the Panel's workplan for the 2023/24 season**

**Commissioning independent analysis of the FY23 Annual Results from Northington Partners**

**Consulting on the proposed 2023/24 season Milk Price Manual changes**

**Discussing with Board Chair Peter McBride the proposed changes to the Board size and composition, and to the size of the Milk Price Panel**

**Discussing with the Board:**

- the executive long-term incentive plan, and
- the decision of the Disciplinary Tribunal of the New Zealand Institute of Chartered Accountants in relation to charges brought against Fonterra's former auditors regarding the audits of Fonterra for FY17, FY18 and FY19.

**Jointly with the Board, commencing a review of the Co-operative Philosophy**

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## **Member feedback and sentiment reported to the Board**

In our July and September reports to the Co-operative Relations Committee, and our October report to the Board, we reported member sentiment was:



- largely positive towards Fonterra's current performance, and
- negative towards the 2023/24 forecast farmgate milk price range.

Our reports also included feedback on:

- the timing and extent of the downgrades to the forecast farmgate milk price range
- sharemilkers and contract milkers being more impacted by the forecast farmgate milk price range than shareholders, given they do not receive payments aligned to shareholding (dividends or any capital return)
- the Farm Source team changes, including:
  - communications on the changes not being timely
  - concerns the outcome will be a reduction in service availability
  - some Area Manager territories seeming to be unworkable in terms of distance, and
  - member difficulties identifying and contacting their new Area Managers
- the impact of this year's extraordinary adverse weather events on Co-operative Difference achievement for the 2022/23 and 2023/24 seasons, and whether flexibility can be offered to those who are adversely affected
- the Co-op's aim to reduce costs by about \$1 billion over the 7 years to 2030, with Co-op member interest primarily in understanding the areas where costs will be reduced
- the recent decision to suspend minor FEI downgrades, including:
  - strong appreciation from members significantly affected by poor on-farm weather conditions that have limited the ability to grow grass

- pockets of negativity reflecting:
  - Fonterra’s change in approach around FEI being seen to be inconsistent with other sustainability requirements that Fonterra has placed on farmers
  - farmers affected by previous droughts having unsuccessfully lobbied for similar treatment
- questions being asked, which included how the processing issues / costs around high FEI milk have been overcome, and the consequences of suspending minor FEI grades on products and customer relationships
- organic suppliers’ concerns, including the decision to cancel plans for the annual organic suppliers’ conference
- timing of the announcement of the Scope 3 target, and farmers’ ability and willingness to engage with increased change behind the farm gate
- Fonterra’s decision to discontinue ‘grade free’ certificates, which were highly valued by some suppliers and sharemilkers
- concerns around farmer well-being with increased financial pressure
- concerns around retention of milk supply and competitor offers, and
- continued feedback on compliance requirements and inspections, discharge to water terms of supply changes, on-line data entry challenges and data duplication, and vat monitoring not seeming to inform collections.

## Letter of Members’ Expectations

Here is a [link](#) to the 2023 Letter of Members’ Expectations which was formally presented to the Board in August.

Council and Board assessments of the extent to which members’ expectations are being met are currently being finalised and will be included in Council’s 2023 Annual Report.



## FY23 Annual Results

On 21 September Board Chair Peter McBride, Bruce Hassall (Director), Miles Hurrell (Chief Executive Officer) and Neil Beaumont (Chief Financial Officer) presented the FY23 Annual Results to Council.



### Areas of focus and questioning

Our areas of focus and questioning of Board and Management on your behalf included:

- The impact of price relativities, including the extent to which Earnings are attributable to favourable relativities on stream returns versus actual performance and good management, and how a high Earnings performance can be sustained into the future.
- The impacts of demand from China on the 2022/23 and 2023/24 season forecast farmgate milk price ranges, and the possible longer term implications of domestic Chinese production.
- The amount of capital employed in, and Earnings from, our Australia business and its medium-term capital investment requirements.
- The drivers of the further impairments to our Co-op’s Asia Brands and the Fonterra Brands New Zealand business, and strategies to address the challenges faced by the Consumer business.

- The current level of debt, recognising the long term aspirations targets are a Debt to EBITDA ratio of < 2.5x and Gearing ratio of <35%.
- The key metrics and targets that Management will be reporting on to demonstrate success in growing Foodservice, strengthening Consumer, and moving towards higher value products in Ingredients.
- How Fonterra will measure and report on the value created from the focuses on New Zealand milk, sustainability, and innovation and science.
- Progress against the long term strategy of investing capital and resources into higher return areas.
- The two new efficiency metrics, including the short-to-medium term priorities and / or identified areas for efficiency savings.
- The new Resource Allocation Framework, including how it will be operationally implemented and its effectiveness monitored.
- The new Asset Health measure, including how the risk appetite is measured.
- The medium term outlook for our Co-op's key markets.
- Competition for milk in New Zealand.
- The drop in Fonterra's share of New Zealand milk collections.
- Culture within Fonterra, including how it is measured.
- Measuring customer retention and new customers.

### Northington Partners' independent analysis

Our independent financial analyst Northington Partners has summarised the FY23 Annual Results as follows:



### FY23 Headlines

All figures are in New Zealand dollars unless otherwise stated.

1	<b>Record Earnings and Return on Capital</b>	Fonterra reported a record full year normalised EBIT of \$1,881m, a material 90% increase on last year's result of \$991m. Favourable price relativities between reference and non-reference products continued in the second half of the financial year, helping to drive a 12.4% return on capital (6.8% in FY22) and a significant improvement in normalised earnings per share (\$0.80 compared to \$0.35 last year).
2	<b>Ingredients Benefit from Price Relativities</b>	Ingredients was again the largest contributor to EBIT at \$1,577m (+\$764m, +94%), with significantly improved earnings from Foodservice as well (EBIT of \$334m (+\$217m, +185%). The Consumer channel reported a loss of -\$156m (compared to EBIT of \$16m in FY22). The Ingredients result reflects a 12% increase in revenue on a 8% increase in volume and an improved gross margin of 15.2% (10.8% in FY22). The loss in the Consumer channel is a result of impairments to the New Zealand Consumer business and Asia brands of \$121m and \$101m, respectively, as well as sustained increases in operating expenses.
3	<b>Milk Price Negatively Impacted by Demand</b>	Fonterra declared a final 2022/2023 Farmgate Milk Price (FGMP) of \$8.22 per KgMS. A total dividend for the year of 50 cents and the 50 cent capital return from the Soprole divestment gave an effective total cash return of \$9.22 per share backed kgMS. The reductions in FGMP throughout the 2022/2023 season were the result of weak international demand for whole milk powder (particularly China), with prices dropping ~16% on average compared to the

		2021/2022 season. This weaker international demand has continued into the current season with the 2023/2024 FGMP being reaffirmed at \$6.00 - \$7.50 per KgMS, with a mid-point of \$6.75 per KgMS. [Note: Since revised to \$6.50 - \$8.00 per KgMS, mid-point \$7.25 per KgMS.]
4	<b>Resource Allocation Framework and Targets Introduced</b>	Fonterra introduced a Resource Allocation Framework to provide a clear structure for operational priorities, the allocation of milk into product divisions and the allocation of operating cashflows to debt, new investment opportunities and distributions. Fonterra’s overall objective is to maximise the risk-adjusted returns for shareholders. To further improve transparency and accountability, targets have also been set for the following key metrics - cash operating expenses per KgMS and gross profit from core operations per KgMS. The combined benefits from achieving the stated targets are expected to remove \$1.0b from Fonterra’s cost base by 2030.
5	<b>Well Positioned for Capital Investment</b>	Fonterra’s net debt has significantly reduced from \$5.3b to \$3.2b. Key drivers included higher earnings, the unwinding of excess inventory from FY22 year end and the application of proceeds from the Soprole divestment. The much lower leverage position at the end of FY23 (Debt/EBITDA of 1.3x vs 3.2x in FY22) means that Fonterra is currently well positioned to meet its capital expenditure requirements and make long-term sustainability investments.
6	<b>FY24 Earnings Outlook</b>	The Fonterra Board has provided forecast earnings of 45 – 60 cents per share for the 2024 financial year. The lower outlook for FY24 largely reflects expectations of reductions in favourable price relativities, partially offset by forecast improvements in Consumer and Foodservice margins.

## Consultation and discussions

### 2023/24 season Milk Price Manual changes

The Chair of the Milk Price Panel and a member of the Milk Price Working Group consulted with Council on proposed changes to the Milk Price Manual to take effect from the 2023/24 season.



They advised that the proposed amendments addressed either minor matters of clarification or requests for additional disclosure raised by the Commerce Commission, and that none would have a substantive effect on the calculation methodology or quantum of the milk price.

Council had no concerns in relation to the proposed changes. The changes are reported in Appendix 2 of the Farmgate Milk Price Statement for the season ended 31 May 2023 [here](#).

### Proposed changes to Board size and composition, and to the Milk Price Panel

Board Chair Peter McBride met with Councillors to discuss the Board’s rationale for the review of the Board’s size and composition, as reflected in communications to shareholders and the presentation at the FY23 farmer results meetings. Council received a draft of the changes proposed to the Constitution and had some queries around the clarity of the drafting of the changes. The Board shared its legal advice on the drafting in response to those queries, and Council had no further concerns.

Council has also received draft changes to the Constitution in relation to the Milk Price Panel which the Board intends to put to shareholders at the 2023 Annual Meeting. Council had no queries in relation to the drafting of those changes.

As both of these changes will alter Part A of the Company's Constitution they require the approval of a majority of 50 per cent of more of members of the Council (as well as shareholder approval).

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## September Council meeting

In late September Councillors met in Auckland to be presented the FY23 Annual Results. See above under **2023 Annual Results** for more on that meeting as well as analysis of the results by our independent adviser Northington Partners.



In relation to the FY23 Annual Results, we also:

- Met with members of the Milk Price Panel (David Pilkington (Independent Chair), Bill Donaldson, Fred Ohlsson and Ming Lim-Pollard), and Peter Goss from the Milk Price Working Group, who spoke to:
  - the calculation of the Milk Price for the season ended 31 May 2023 (as reported in the Farmgate Milk Price Statement [here](#))
  - the Commerce Commission's final report on the 2022/23 season milk price
  - the Panel's work plan for the 2023/24 season, and
  - this year's amendments to the Dairy Industry Restructuring Act 2001 in relation to the governance, and potentially to the calculation, of the milk price.

All members of the Panel responded to our areas of questioning which included:

- the extent to which Fonterra's plans regarding sustainability investment impact the calculation of milk price, and
- the extent to which the Fixed Milk Price offering impacts the calculation of the milk price, noting Council was advised 'not at all'.
- Met with external auditors KPMG to discuss their FY23 audit processes and findings. Our questions focused on:
  - the impairments, including the change in valuation approach for Fonterra Brands New Zealand
  - the gap between Fonterra's net asset value and the Fonterra Co-operative Group Limited share price, and
  - international auditor rotation practices (audit firm and / or lead audit partner).

While in Auckland we also:

- Met with Anne Douglas (Director Farm Source) and members of her team, for a presentation and discussion on:
  - Fixed Milk Price, including the extent to which it was used by Co-op members during the 2022/23 season, how it supports the Co-op and our customers, and how it might evolve, and
  - the recent Farm Source structure changes, including the reasons and aims, and how success of the changes will be tracked and assessed.
- Met with Simon Till (Director Capital Markets) and a member of his team who spoke to:
  - why Fonterra hedges foreign exchange risk (noting the graph included in the FY23 presentation to farmers showing the sensitivity of the milk price hedged versus unhedged, and that there also information in the Fonterra Farmgate Milk Price Statement [here](#))
  - Fonterra's foreign exchange risk and sales hedging strategy, and

- a recent independent review of Fonterra's foreign exchange hedging policy, which Council was informed was highly supportive of Fonterra's current approach.

Councillors found the presentation highly informative and Council will be recommending to the Board that a webinar is offered to Co-op members covering the content shared with Council.

- Met with Board members Peter McBride, Bruce Hassall and Holly Kramer to discuss questions Council had raised about the Fonterra executive long term incentive plan (noting there is information on this in the Fonterra Governance & Statutory Disclosures 2023 document [here](#)).
- Received presentations from Management on:
  - the Greater China business, and
  - the mandatory climate-related disclosures regime.

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## Applications to become an Appointed Councillor



Following an assessment of Councillor skills and diversity, Council is looking to appoint an additional Appointed Councillor and late last month invited applications from all Co-op members.

Appointed Councillors do not represent a particular Ward. They help support Council's representation of all Co-op members.

The purpose of the appointment is to address one or more of the following diversity gaps within Council:

- Councillors who are currently sharemilkers or contract milkers
- Councillors with a System 1 dairy operation system
- Councillors who identify as being of an ethnicity or nationality other than NZ European / Pakeha
- Councillors who are multi farm suppliers to Fonterra from three or more farms.

Applicants do not need to have a direct or indirect interest in a Shareholder that is supplying Milk to Fonterra to be eligible for appointment.

Further information on Council's role, the position available and the application process is available in the Candidate Handbook [here](#).

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## Coming up

Over the next few months we will be:

- finalising Council's assessment of the extent to which members' expectations, as set out in the 2022 Letter of Members' Expectations, are being met
- finalising our 2023 Annual Report
- holding Councillor led meetings across all Wards to discuss Council activities and to provide an open forum for members to raise questions and provide feedback - look out for an email invite soon or contact your Ward Councillor for details
- overseeing the 2023 Director and Directors' Remuneration Committee elections, including hosting eight Director candidate meetings around the country and one online meeting



- progressing, with the Board, a review of the Fonterra Co-operative Philosophy, and
- hosting the Understanding Your Co-operative Programme (UYCP) at the Fonterra Centre, Auckland in December.

All Co-op members are welcome and encouraged to attend the UYCP. Contact your [Ward Councillor](#) for further information.

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## Questions put to the Board



One of Council's functions is to seek Board explanation of, and responsibility for, Fonterra's strategy and performance.

One of the ways we do this is by adopting a regular and consistent approach to questioning the Board.

Set out below are four questions we put to the Board in writing this quarter and its responses.

### **Q: What key achievements were made during Q4 that demonstrate the implementation of Fonterra's strategy?**

**A:** Fonterra delivered a third consecutive year of strong overall performance, despite facing into difficult market conditions in several regions.

Reported profit after tax was up 170% on last year to \$1.6 billion, equating to earnings per share of 95 cents up from 36 cents.

We exceeded our return on capital expectations, with a ROC of 12.4%, up from 6.8%.

This strong earnings performance enabled us to pay a full year dividend of 50 cents per share and unit.

The Co-op also returned 50 cents per share and unit following divestment of our Chilean business, a key commitment we made to shareholders in 2021 when we released our long term strategy.

This has, however, been against the backdrop of a Farmgate Milk Price that has dropped across the season.

Our 2022/23 season Farmgate Milk Price was impacted by reduced demand for whole milk powder from key importing regions. As the financial year progressed, we saw Global Dairy Trade prices drop, with the average whole milk powder price down 16% compared to last season.

We recognised the impact the reduced Farmgate Milk Price has on farmers' businesses and utilised our strong balance sheet to introduce a new Advance Rate Schedule guideline to assist on-farm cash flow.

As part of our ambition to be a leader in sustainability, we increased our Scope 1&2 emissions target to 50% by 2030, an increase on our previous 30% target, assisted by a government contribution (through the Government Investment in Decarbonising Industry fund) of up to \$90 million.

Looking at on-farm emissions, we held conversations with farmers across the year about the need to introduce a Scope 3 target. We also co-invested with Government and other industry partners to develop new solutions to on-farm emissions through the establishment of AgriZeroNZ.

We progressed work in our innovation portfolio as part of our ambition to be a leader in dairy innovation and science. We established our joint venture with Royal DSM, Vivici, which is exploring commercial opportunities in fermentation derived ingredients, utilising Fonterra's IP.

We also launched our corporate ventures arm Nutrition Science Solution (NSS), which is exploring long-term opportunities to invest in and scale nutrition science start-ups. In FY23



NSS made its first strategic investment in the form of a minority stake in Pendulum Inc, a biotech company specialising in metabolic health.

**Q: How well is Fonterra ‘on-track’ for meeting its current strategic objectives?**

**A:** Overall, Fonterra is on track to meet its objectives. A clear plan is in place to deliver our target 2030 RoC of ~9-10%.

To assist us to hit our short and long-term goals, we are implementing a range of projects that will streamline how we operate. To help track our progress, we have introduced two new metrics.

These are:

- Cash operating expenses per kgMS – targeting a 4% cash operating cost improvement per year to support long-term discipline in our global overheads.
- Gross profit from Core Operations per kgMS – targeting a 2% New Zealand operational cash cost improvement every year to support efficient New Zealand operations while remaining laser focused on delivering value.

We are also updating our long-term strategy and plan to share this early next year.

**Q: What new and/or emerging challenges is Fonterra facing, in relation to its strategic objectives, and how is it responding?**

**A:** Looking ahead, our forecast 2023/24 Farmgate Milk Price range is \$6.50 - \$8.00 per kgMS, with a midpoint of \$7.25, which reflects both supply and demand dynamics.

Here in New Zealand, we’re forecasting milk collections to be slightly below last season, while aggregate milk growth in key export countries is expected to be below average for FY24. The El Niño weather pattern may have further impacts on supply.

We are also keeping an eye on any impact changes in our shareholder base might have on our milk supply. Fonterra’s number of shareholding farms has decreased over the past three seasons due to a number of factors including consolidation of farm ownership, farms moving to alternative land uses and farms switching to other processors. Our market share of New Zealand milk was 79.0% in FY21 and 79.1% in FY22 before going back to 79.0% in FY23, due to a small net loss of milk supply to competitors.

Overall, our milk collections in New Zealand on a milk solids basis increased slightly this past season, from 1,478 million kgMS in 2021/22 to 1,480 million kgMS in 2022/23. Our forecast collections for the 2023/24 season are 1,465 million kgMS.

On the demand side, we have seen increased prices in recent Global Dairy Trade events. While this has been encouraging, it is not yet clear whether the stronger demand from China will be sustained. For other key regions, customers remain relatively cautious in terms of their forward purchases.

Our foreign exchange hedging strategy is designed to help lessen the impact of exchange rate volatility, and also supports a higher Advance Rate level than would be possible without hedging.

From an earnings perspective, our FY24 forecast earnings range for continuing operations is 45-60 cents per share. While the favourable price relativities we’ve experienced across FY23 have reduced from their peaks, we are forecasting improved margins across our Consumer and Foodservice channels for FY24.

We acknowledge that across the year, farmers will continue to feel the pressure from high input costs and a reduced Farmgate Milk Price. We’ll continue to do all that we can to support farmers through this challenging period.

**Q: Are the three strategic choices – continue to focus on New Zealand milk, be a leader in sustainability and be a leader in dairy innovation and science – still ‘right’ for our Co-op?**

**A:** We test the beliefs, or assumptions, that underpin our strategic choices every six months, and remain confident that these choices are still right for our Co-op.

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## Tell us what you think

Did you find this Update useful?

Please [click here to answer four short questions](#) to help us make it more relevant to you.



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