KPMG
cutting through complexity

PROSPERITY, DAIRY AND UNLEASHING THE GIANT

AN ANALYSIS OF THE FONTERRA SIGNALS

24 SEPTEMBER 2015

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FUELLING PROSPERITY

FUELLING NEW ZEALAND'S PROSPERITY

KPMG is focused on fuelling the prosperity of New Zealand. By prosperity, we mean shared wealth and lasting well-being for all New Zealanders.

This is more than a goal – it is our reason for being. It is driven by our overarching passion for New Zealand and our desire to stand for something that is truly inspiring and worth working towards. This purpose means we are constantly engaged in the debate about how best to unlock our nation's potential and fuel prosperity for everyone.

New Zealand's Dairy industry, and in particular Fonterra, is vitally important. KPMG believes the Dairy industry and New Zealand's prosperity are intrinsically linked, and it is therefore critical that the debate and action is informed. That is why we have engaged a senior team to look closely at the 'industry signals' and provide an independent view on the impact that the Dairy Industry and Fonterra will have on the prosperity of New Zealand.

While New Zealand's position in the global economy over the last 40 years has deteriorated, we have emerged from the GFC with strength and signs that we can build upon. In the last five years, New Zealand's exports have grown by $16b (24%), and 45% of that growth was contributed by the Dairy industry. Putting it bluntly, our economy is in good shape because of the Dairy industry, and in particular Fonterra. New Zealand needs this to continue. There is little chance of achieving the Government's goal of doubling exports by 2025 without our most important sector delivering.

While the current climate for Fonterra and the Dairy industry is tough, the positive signals we see now are very important to New Zealand's prosperity in the medium-term. The key signals we highlight are:

- Fonterra's value-add food service and consumer business (excluding value added ingredients), is expected to be worth $7b in 2015 . This is more than the entire value of New Zealand's red meat sector.
- The food service and consumer business has grown by around $2b in the last five years. This is more than the entire value of New Zealand's Horticulture exports.
- Fonterra has three consumer brands of global significance (Anlene, Anmum and Anchor), three dominant regional brands, and a recognised value-add ingredients brand. To put this into perspective, that there are no other consumer brands in New Zealand that have a chance of getting close to $1bn in sales. These dominant brands are what is required to be globally relevant.
- Fonterra has initiated a major operational review that will not only deliver significant benefits, but even more critically, will enable Fonterra to move at an increased pace.
- The transformation project is not a reactive change in strategy – it is positive signal that Fonterra is accelerating the pace of driving their current strategy.
- Our projection is that Fonterra will deliver a record profit result for the second half of this financial year.

KPMG has analysed the above signals, in order to address the following two fundamental questions:

- What are the signals to stakeholders that could give confidence that Fonterra is on a flight-path for $35b in revenue and EBIT of $3.5b?
- Secondly, what are the implications of achieving a $3.5b profit? Both in terms of the ability to push past the $35b revenue, and for the $3.5b EBIT to provide a potential buffer for suppliers to better manage price volatility.

Putting Fonterra's importance to NZ in perspective

2014

$22b FONTERRA GLOBAL REVENUE

New Zealand's Dairy export sector, at $18b, is 38% of all merchandise exports and 28% of total exports (including services)

$19b VALUE OF ALL OTHER AGRICULTURE EXPORTS

2009-2014

$6b GROWTH IN FONTERRA REVENUE

(includes overseas revenue)

Fonterra grew by 27% – this equates to 32% of New Zealand's export growth and compares to $5b increase in all other merchandise exports.

$5b GROWTH IN VALUE OF ALL OTHER MERCHANDISE EXPORTS

2014

$6b FONTERRA'S FOOD SERVICE AND CONSUMER BUSINESS

(excludes value add ingredients)

The value of Fonterra's food service and consumer business is as large as New Zealand's total red meat exports.

$6b TOTAL RED MEAT EXPORTS

(commodity and value add)

2009-2014

$2.5b GROWTH IN FONTERRA'S FOOD SERVICE AND CONSUMER BUSINESS

(estimated)

Fonterra's foodservice and consumer business is estimated to have grown by $2.5b (2009-2014 $b). This is the equivalent of New Zealand's total horticulture exports.

$2.5b TOTAL HORTICULTURE EXPORTS

PUTTING IT BLUNTLY, OUR ECONOMY IS IN GOOD SHAPE BECAUSE OF DAIRY, AND IN PARTICULAR FONTERRA, AND NEW ZEALAND NEEDS THIS TO CONTINUE

Ross Buckley
Executive Chairman

FONTERRA

Fonterra's strategy – past, present and future

Fonterra has been deploying its current strategic path for four years, as it looks to establish itself as the most trusted source of dairy, and in doing so, make a difference to two billion people. The 'volume, value and velocity' strategy builds on the core building blocks of integrated supply, efficiency, global number one supplier of milk and trader in dairy products.

While there have been no diversions in strategy, there have been major hurdles presented from external events – including the WPC80 precautionary recall, the 1080 threat, and now the impact of unprecedented global supply/demand rebalancing. Dealing with these significant diversions has probably cost the enterprise the equivalent of two years' strategic progress.

The strategy Fonterra is deploying should be seen as a 10-year programme that will systematically transition the business from the world's most competitive dairy supplier, to being a globally relevant food business.

Three points to note:

- **It's creating value.** Fonterra is systematically building volume through a truly integrated value chain and transitioning more product into areas that produce higher margins. i) Food Service ($1.5b), ii) Consumer Products ($5b) and, iii) High Value Ingredients (there are limited numbers available on this but based on the GDT sales this could be as high as $7b).
- **It makes sense.** Fonterra is capitalising on the advantage of its integrated business model and superior access to milk pools to systematically build its position through key brands in a limited number of critical markets and product segments (Food Service and High Value Ingredients are part of this). At the same time, it is leveraging its commodity business to flex and adapt where there are supply, demand or price changes.
- **It takes time**. For example, there are 100 relevant megacities globally in which Fonterra could look to establish a dominant position for any of its consumer brands. Building a dominant position in any of these cities is a strategic initiative in its own right, and probably requires a minimum of four years' investment.

The key external observation is that in tough times Fonterra is not moving away from this strategy, but is reinforcing it. What might not be recognised or truly understood is the impact of specific events, outlined above, which have probably delayed the real deployment of this strategy by at least two years. These events have absorbed the focus and resources of the board, management and wider organisation. The current business review recognises this, and effectively fast tracks the response.

The challenge is not the coherence or relevance of the strategy, but the ability to implement this strategy with pace and discipline. The fundamental question becomes: if Fonterra deliver this strategy, will it move the EBIT to 10% of revenue? That is the level of profitability required to move to the next level and protect milk suppliers from the inherent price volatility.

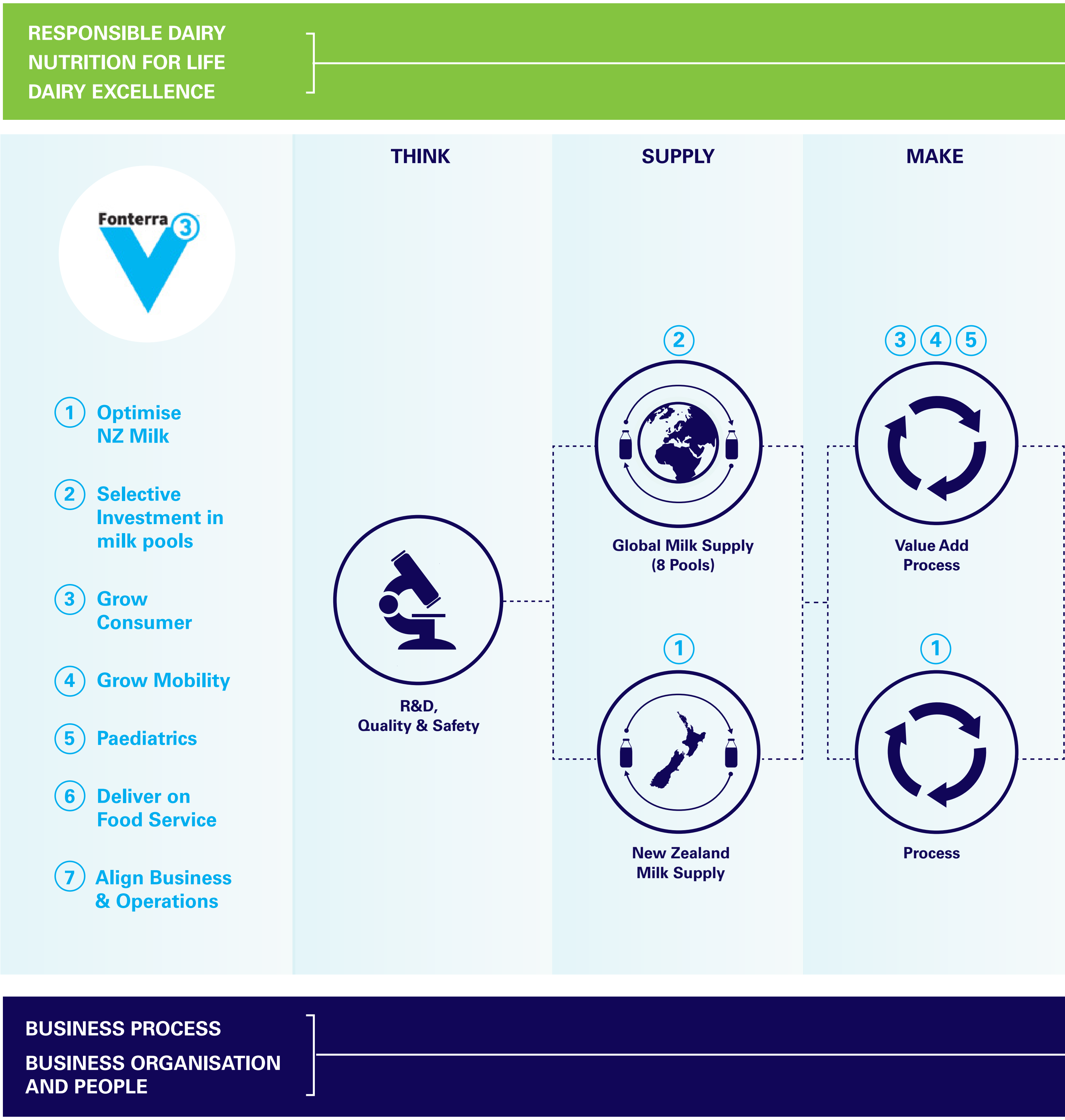
This is game changing. It is the EBIT impact that will unleash the giant.

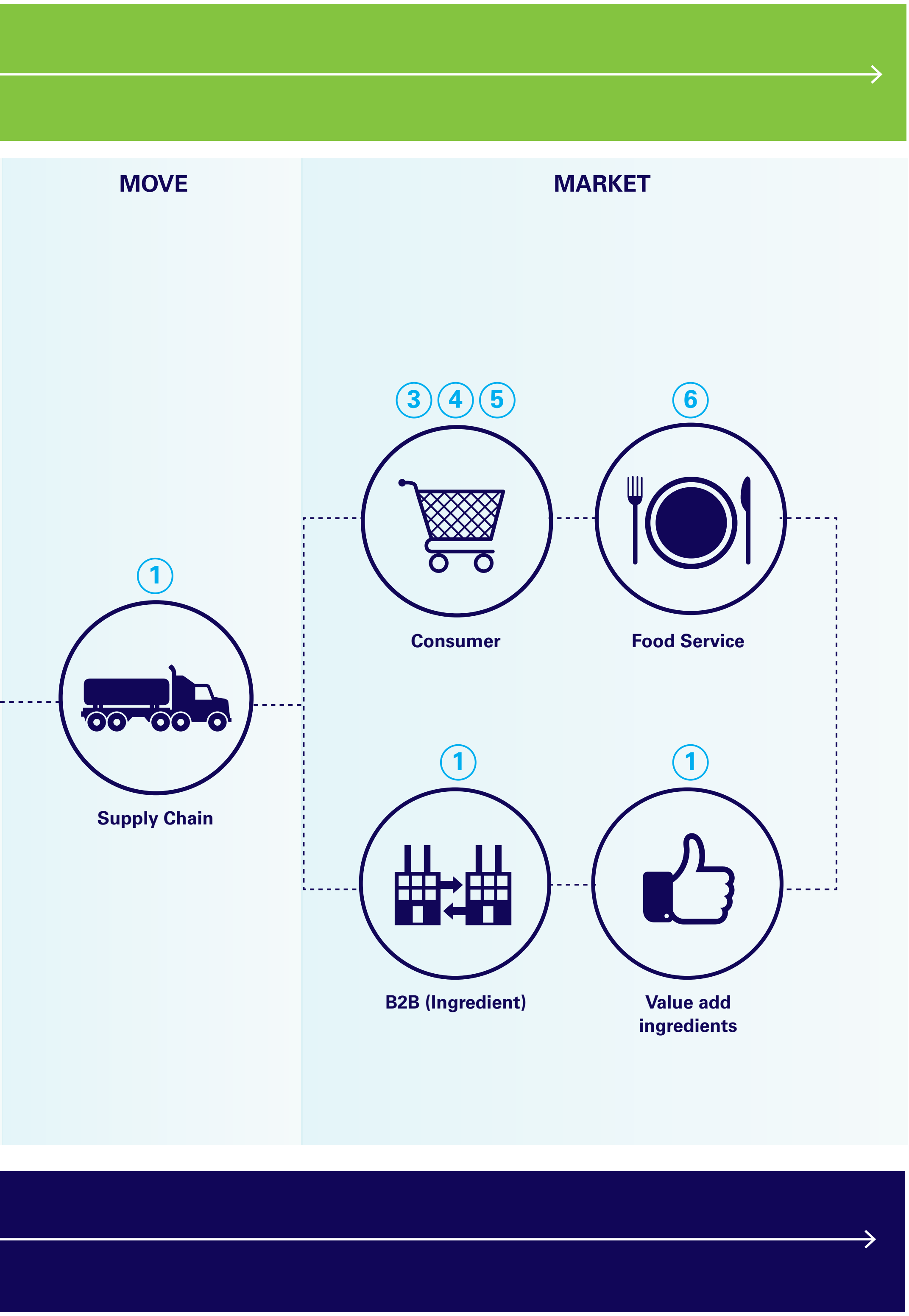
THE STRATEGY IS COHERENT BUT KEY EVENTS HAVE DELAYED THE IMPLEMENTATION BY AT LEAST TWO YEARS – FONTERRA HAS LEARNT FROM THIS – I WOULD NOT EXPECT THIS TO HAPPEN AGAIN

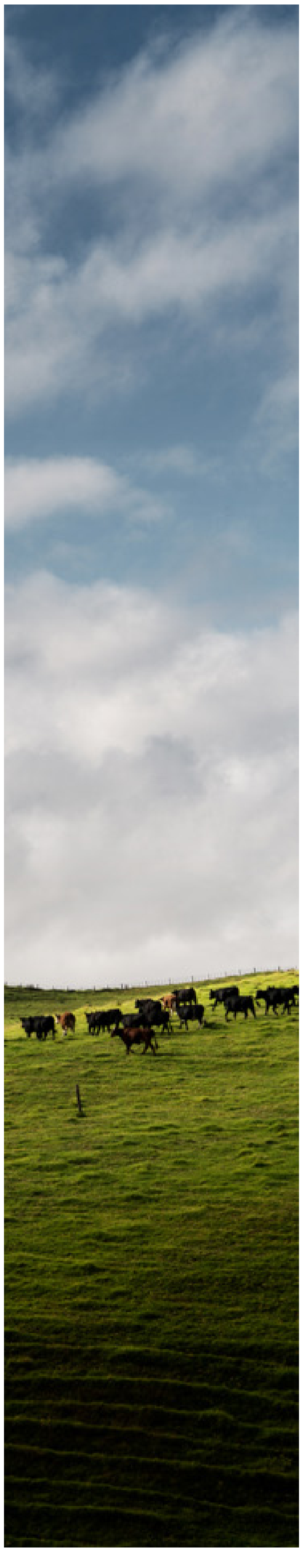
Paul Dunne
Partner

An overview of Fonterra's strategy

The most trusted source of dairy nutrition




MOVE
MARKET
3
4
5
6
Consumer
Food Service
1
Supply Chain
1
1
B2B (Ingredient)
Value add ingredients



DAIRY UNCERTAINTY

What is it like to compete in this industry? Does it make sense to play in this space?

Consumer food is a tough industry, and dairy is certainly at the tougher end of the spectrum. There are factors close to the consumer end of the value chain that are challenging. Changes in consumer dynamics, the power of mega brands, supermarket consolidation and power, and rapidly increasing complexity at all stages along the chain can all have a significant impact.

For the Dairy industry, we can add the sensitivity of supply to environment changes, rapid changes in demand, the inability to turn off supply, and issues of decomposition (raw milk is converted to a complex range of products and by-products).

KPMG's analysis of the global dairy dynamics is that uncertainty and volatility is inherent to the industry. Participants in the industry should expect disruptions. To be successful, the industry requires a combination of discipline and agility, which is where Fonterra's focus appears to be moving.

KPMG's uncertainty wheel (right) does highlight a number of positive dynamics for the industry – including demographics, urbanisations, significant global growth of middle class, and the economic power shift to Asia. There are also factors that are tough for the industry, but New Zealand has a comparative advantage when it comes to factors such as natural resource constraints, resource regulations and compliance systems.

For New Zealand and Fonterra, the uncertainties KPMG believes will be pivotal include:

- **Consumer perception and needs/ food needs and rise of the individual.** This includes the relative ability to get close to customers, understand customers' increasingly diverse and complex needs, maintain customers' trust and adapt the supply chains. The customer environment is being disrupted at pace, and it is going to take capability, technology and significant investment just to keep up.
- **Human resource and capability.** Currently, the New Zealand sector is not developing, retaining and attracting the increasingly diverse and specialist people required across the entire value chain.
- **Technology transformation (Agri, Product, Supply).** The ability to develop and deploy new and innovative technology (e.g. bio, genetic, product, engineering and information technologies) is likely to be a critical determinant of industry success – and New Zealand's resources are currently constrained. This is potentially the game-breaker for dairy, both within dairy and relative to other food categories.
- **Industry structure and value chain evolution.** The future will bring evolution of the industry value chains (in particular supply chain integration where Fonterra is well positioned), brand consolidation and the evolution of mega brands with sales of $>5b, supermarket consolidation, and channel divergence (spanning supermarket, online, niche and specialist). The beer industry trend where four companies now control over 50% of all beer sales provides some insight into the direction for dairy.

KPMG's overall assessment is that Fonterra's integrated business model and relative scale are an advantage, but it can't afford diversions. All dairy companies face challenges; and while Fonterra's capabilities currently in place have kept them in the game, it will not be enough to win in the future. In these tough times, a breakthrough for Fonterra would have a significant impact and stakeholders need to see the signs of this.

Critical uncertainties for Fonterra

CLEARLY IT'S TOUGH IN THE INDUSTRY, BUT WHAT MY CLIENTS REALLY NEED TO SEE IS FONTERRA TAKING ADVANTAGE OF THIS UNCERTAIN ENVIRONMENT... I DON'T EXPECT THEM TO BACK OFF AND BE TIMID

Roger Wilson
Partner

SIGNALS TO BUILD CONFIDENCE

Fonterra is New Zealand's most significant enterprise. Its revenue equates to 2.5 times that of Fletcher Building, 10 times the next largest New Zealand agri-business enterprise, and equal to the total revenue of the Government's 18 SOEs and 19 Crown-owned enterprises. Fonterra's revenue equates to the total value of all other agri-business, and its value-add business and growth of business dwarfs all other metrics. Fonterra has reached this scale within 12 years. Fonterra is important to New Zealand's prosperity and is a good news story.

KPMG's assessment is that the top 10 signals to focus on include:

1 The EBIT result

Lifting EBIT is now Fonterra's most critical challenge. EBIT at 5% of revenue is too low and 8%-10% would bring Fonterra more in line with expectations. The flight path analysis (page 18) suggests this is achievable. The combination of a $600m EBIT for the second half of 2015, along with confirmation of the operational improvement benefits, would indicate $1.5b should be the short-term EBIT target, with $3.5b as the long-term target. Achieving this is critically important – this is what is required for next-level growth, and to protect Fonterra's suppliers from milk price volatility. A $1.00 improvement in Earnings Per Share is crucial, and the operating improvement and projections from 2015 show this is starting to work.

2 Maintaining a competitive level of investment

Fonterra's investment over the last year has included $2b to grow the consumer business, along with significant investment in stainless steel. The latter finally gives Fonterra the capacity to optimise the product mix during the peak period, which is critical to the value-add business. Fonterra's capex levels have been consistent with its competitors (with capex at 5% of revenue and approximately 7% of total assets compared to peers at 5%). The current restraint on capex is understandable, but not a long-term proposition. Reversing this constraint should be signalled with the upcoming results.

3 Product innovation and market leadership

Fonterra has already signalled that a significant part of the recent cost savings will be re-applied to value-building activities. This will see Fonterra invest more in market and look to leverage this in innovation, which is vital given the emerging complexity of consumer needs and opportunities. The best example of this is the 500% growth of nutraceuticals over the past 20 years, and the expansion of food service products. These are the sort of opportunities that Fonterra should highlight in future communication.

4 Ability to respond to the challenging operating environment

Global competition and supply has increased (from Europe and USA), and demand reduced (from China and Russia). Inventory is high and prices are low and volatile. These fundamentals impact the entire industry, and will reshape the competitive landscape with many opportunities emerging. The timing of these opportunities is not ideal for Fonterra as it goes through its review process and manages milk process volatility, but they are not straying from strategy.

5 Recovery/strategic focus/ implementation

The red flags for Fonterra come back to the two major events (WPC80 and 1080) and their response to global supply/demand rebalancing. These have diverted strategic focus and resources. Fonterra cannot afford another diversion, but there are positives. Fonterra is more resilient. The 1080 event showed ability to manage a crisis to the same standard as global leaders like Air New Zealand. The business review is decisive, and will deliver value over-and-above the savings from the announced headcount reductions. This is a new Fonterra in action.

6 Protecting the foundation

Fonterra's foundation is built upon a solid platform of efficient farm and primary processing, 10,000 cooperative suppliers, and an integrated supply chain that makes them No.1 in globally traded dairy. This gives it a competitive advantage over all other global dairy organisations. Fonterra has retained this, and the emphasis is on leveraging rather than replacing it. It is reassuring that Fonterra resists the calls to separate its consumer and commodity businesses. Milk is a complex resource made of 3,500 natural components, and there is significant advantage in the integrated business model from optimising the complex mix of high value and by-product components.

7 Leveraging the environmental and social responsibility track record

Fonterra is surprisingly passive in how it is informing stakeholders of its success in this space. There are challenges related to water, but Fonterra has delivered more in this arena than any other enterprise in New Zealand. Global analysis clearly highlights the importance of this to global consumers and the opportunity to build price premiums because of this. Fonterra is now able to give this greater prominence in its messaging.

8 Trust

Trust is fast becoming the most important factor in consumer purchasing decisions. Consumers, particularly of food products, do not purchase from companies they do not trust and will pay premiums to those they do. The critical events of the last three years had the potential to undermine trust for Fonterra. Fonterra's experience with WPC80 has driven a major change in its approach and Fonterra is now investing in the most advanced systems in the world to manage food safety. Over four years, MPI listed 69 food recalls, including 12 dairy product recalls – of these, Fonterra had just two events. During this same period, one of Fonterra's global competitors had 10 global recalls.

9 Leadership in brands, markets and cities

The world's top 10 food and beverage enterprises (excluding alcohol) control US$500b of revenue (approximately 7% of the global food and beverage market), and each have multiple billion-dollar brands to lead in selected categories. They are dominant players in the worlds 400 cities of significance (with populations of 300m). Fonterra's simplified family of brands (3 global brands and 3 regional brands, plus NZMP for value-add ingredients and Food Service) makes them globally relevant in this world.

10 Leading in Food Service

Fonterra's Food Service business should potentially be recognised as the jewel in the crown. Specific figures on this business are unknown but our assessment is the business is significant (i.e. worth more that New Zealand's total wine exports), very profitable and growing fast (>15% per annum). Fonterra is already winning in this market, which is expanding rapidly. In the USA, out-of-home food sales have grown from a third of all food sales in 1990, to half today. As Asia follows this trend, the market opportunities are massive – and Fonterra is already in the number one spot.

The picture confirms that there is hard work to do (see challenges on page 10) but on balance, the signals are positive. KPMG believes the signals underpin a flight-path to a $3.5b EBIT.

IT'S EASY TO SEE A $3.5B EBIT, THE CHALLENGE IS DISCIPLINE AND PACE

Simon Hunter
Partner

GLOBAL RELEVANCE AND RESILIENCE

SOLID FOUNDATION

Fonterra is an organisation that evolves with pace. In 10 years it has added $10 billion (80%) worth of sales. Milk volumes have increased by approximately one third.

While the magnitude of structural change is significant, it is only a foundation toward being a globally relevant cooperative with global leadership in the dairy industry (30% increase in milk volumes and 60% increase in revenue by 2025) which will be enabled by ongoing changes.

Fonterra has a solid foundation. The challenge is to unleash the organisation to go faster and realise opportunity while competitors are struggling.

New Zealand supply – 10,000 cooperative and competitive farmers (shift productivity).	Track record of growth ($10b in 10 years, 18% milk growth in the last 4 years).	Number 1 supplier of milk and trader of dairy product. Number 4 dairy firm in the world.
Science of milk solids decomposition and optimisation.	Global milk pools.	Integrated, cooperatively-owned value chain.

GREEN LIGHTS

Fonterra shows several positive signals:

- Rapid change in cost structure
- Progress toward sustainability as a competitive advantage
- Progress toward food safety as a competitive advantage
- Rebalance of domestic capacity (increased capacity, vs reduced supply with have positive impact)
- Adjusted economic fundamentals (exchange rates)
- Global market leadership
  - No.1 in ingredients
  - No.1 or 2 in Chile, Sri Lanka, Malaysia, New Zealand, China, Brazil and Indonesia
- Strategic focus on Anchor, Anlene and Anmum
- $1bn invested in consumer business (includes BeingMate, Brazil)
- Coherent and consistent strategy with Board and management committed to this – no signal of change
- Shift in product mix towards consumer business

The dairy operating environment is complex and dynamic. Many factors are driving a rebalance. This is the time for Fonterra to focus on opportunity.

SUPPLY

9 million tonnes increase from Europe (equates to 20% of global trade)

DEMAND

9 million tonnes decrease in China and Russia in 2015 (8% of trade)

RED LIGHTS

There have been fundamental issues that have acted as a handbrake and consumed resources. This delayed strategy deployment by at least 24 months but has proven the resilience of the organisation.

- 1080
- WPC80
- Demand adjustment (e.g. Chinese reduction in imports)
- Supply (US and European growth)
- Dairy trade still distorted by global business

AUGUST MESSAGE

Bleak forecast but includes very confident signals of change

- Not changing strategy. Confidence in direction, cooperative and resilience of organisation
- 40 to 50 cents for earnings per share (EBIT back toward $1bn).
- $3.85 per kg/MS (better than most forecast)
- Confidence in return to $6kg/MS – $0.50 interest free loan for 2 years repayable at $6kg/MS
- Flexibility if grow EBIT to keep investing

Three points are fundamentally important in the short term

- What is the EBIT for 2015 (will it be $900m as projected by analysts)
- How quick will milk price move (Fonterra suggest 6 months)
- How quickly will Europe reduce production (a 1% reduction in Europe equates to a 3% reduction in global exports)

SEPTEMBER SIGNALS

The signals that would give stakeholders confidence in September 2015 may include:

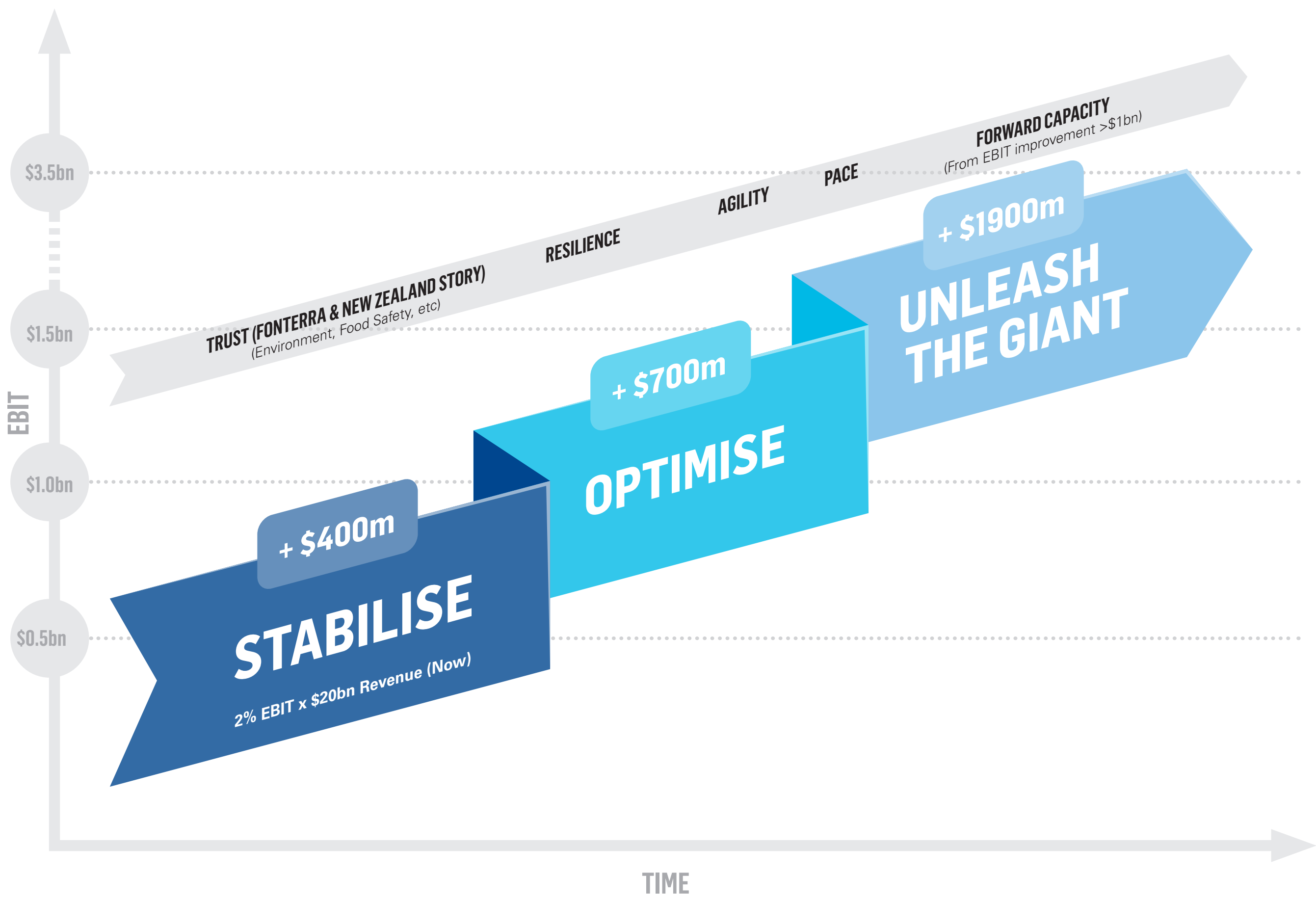
- Financial savings to release resources and lift EBIT by 2% to 3%
- Optimisation of working capital.
- Reinvestment of resources into R&D. product innovation, sales and marketing
- Increase in pace of change
- Reinforcement of change in culture

CAUTIONS

- Rebalance of global supply and demand
- Management focus on the right issues (24 month delay)
- Supply chain shaped for the consumer business
- Simplification of brands and capabilities to build these mega brands with $2bn revenue each
- Trust and ability to convert supply and product attributes to value
- Still have to play in a global environment that is changing

FLIGHT PATH FOR FONTERRA RESULTS

Where is the value?
What are the signals?



STABILISE

2015 recovery (February to July $400m USD)

OPTIMISE

EBIT Impact

- Milk price impact on consumer business
- Product and price optimisation (mix and better control of above the line spend)
- Supply vs. capacity balance (reduced cost plus better product optimisation)
- Input optimisation (good and services, current transformation project)
- Labour optimisation (approximately 750-1,000 FTEs)

Investment

- Increase sales and marketing (0.5% of revenue investment)

UNLEASH THE GIANT

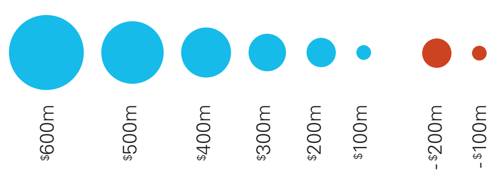
EBIT Impact

- Growth from milk pools (between $20bn to $30bn)
- Turn the wheel faster:
  15% Global dairy trade
  35% Ingredients
  40% Consumer
  10% Food service
- Improve LATAM consumer business
- Recovery of Australian consumer business

Investment

- Milk price impact on consumer business

KEY



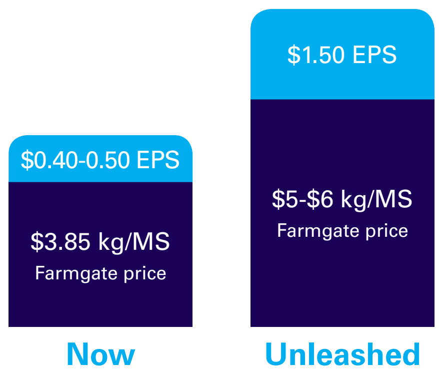
What could this mean for New Zealand? By 2025 Fonterra could achieve:

$35bn REVENUE
10% EBIT
$3.5bn EBIT
$1.50 EPS

The potential outcome is compelling:

- NZ production increase at 2-3%pa.
- Sustainable supply as a source of competitive advantage
- Globally relevant, Number 2 global dairy business: $30bn
- Reduced exposure to pure commodities to 15% of revenue
- Increased consumer product sales to 50% of revenue
- Capacity for growth (EBIT to fund consumer business equates to $2b)
- Built-in resilience for suppliers: $1.50 EPS
- 4 brands of over $2b

The flight path is important to New Zealand. How do we bring the focus back to this?



CHALLENGE SIGNALS

There is evidence that the flight path is achievable, but it is not without challenges. The critical challenge is best summarised as 'velocity'. The opportunities are clear, some competitors are struggling, Fonterra's foundation is strong and their strategic roadmap makes sense. Success, however, will be driven by implementation. With a cohesive Fonterra lead team that is clear of distractions – and with the benefit of experience and the latest business review – there are no excuses for failure.

There are five further challenges that KPMG believes Fonterra's stakeholders should focus on:

1. **Access to capability.** To truly deliver on strategy, Fonterra will require new capability. The re-organisation has released resources, and will enable investment in critical new capabilities – from innovation to marketing and consumer engagement. Access to global talent and experts is potentially the greatest constraint here. This talent is essential to underpin the growth required to compete with global brands, and to drive the ongoing transformation of Fonterra's product and market portfolio.
2. **Pace of change.** Fonterra is operating in an environment of disruption and change. The competitive reality is that Fonterra along with its suppliers and partners are actually in a relentless race to develop and deploy new technologies (bio, genetic, product, engineering and information) at every stage of the value chain. The pace is increasing and some of Fonterra's competitors have superior resources and better business ecosystems. If Fonterra cannot keep pace then the whole of the agri-business sector will be challenged. This may require an Aoteroa Inc. solution that is more effective than the current PGP system. It also suggests that Fonterra's obligations under DIRA may no longer be appropriate.
3. **Collaboration and partnering.** The scale of the opportunity, pace of change, need for innovation and capital constraints means that Fonterra will only deliver if it becomes exceptional at collaborating and partnering. Recent history signals that Fonterra has skills in this area. Examples include the transaction with Beingmate, reshaping Dairy Partners Americas, the Dairy Crest partnership, and the joint ventures with A-ware and with Abbott.
4. **Connecting to the New Zealand story.** As consumer needs become more complex and trust is more important, there is huge value in Fonterra connecting more effectively with the New Zealand story. Fonterra's global focus means that this has been underemphasised. This is particularly the case in its slow development of its relationship with Māori.
5. **Capturing the hearts and minds of the stakeholders.** The public perception of Fonterra remains a constraint. This will take time and focus to address, but the signals are increasingly positive. We can point to the collaborative industry response to 1080, the real progress on environmental action (the 95% exclusion of stock from waterways and 32,000km of waterways fencing is a massive achievement), and the deeper engagement with the community (schools, the All Blacks, etc).

I DON'T ENVY FONTERRA... THERE'S HISTORY TO OVERCOME AND IT'S A TOUGH GAME THAT'S GOT TO BE PLAYED AT PACE

Ian Proudfoot
Partner

CONCLUSION

Fonterra is of massive importance to New Zealand's prosperity. It is on a flight path for growth – and it's a path that is reasonably easy to understand, and to track progress.

KPMG has analysed the signals, and we believe this flight path is achievable for Fonterra.

It will mean the organisation will need to continue to adapt and improve. It will need to deliver with discipline and rigour. But the fundamental signals point to an opportunity to really unleash the giant, and that is exciting.

There is also a responsibility for Fonterra's stakeholders – who need to invest effectively in the relationship, to dig deeper, and understand. If we can do this for Dairy, it will flow through to other sectors and ultimately to New Zealand's prosperity. That is important and worth engaging in.

THIS IS A TIME FOR NEW ZEALAND AND FONTERRA TO FOCUS ON OPPORTUNITY

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Partner

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