

Market Commentary

FONTERRA'S BOND ISSUE SOLID

NZFUNDS

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Positive global conditions provide Fonterra with a positive tailwind for an upcoming bond issue, says NZ Funds Principal, Mark Brooks.

Fonterra have announced to the NZX that they are considering an offer of senior unsecured bonds to the New Zealand debt market during February or March of this year. Initial indications suggest a maximum issue size of NZD\$250m with the proceeds being used to partially refinance an existing Euro denominated bond which matures in April 2010.

This potential debt issue coming almost to the year to the day since Fonterra raised NZD\$800m in one of New Zealand's largest retail bond issues, so how have the company fortunes changed over the last year?

At the beginning of 2009 Fonterra faced two significant challenges – milk prices and its co-operative capital structure.

The most pressing challenge was the impact of the global financial crisis on milk prices. Whole milk prices enjoyed a bull market run throughout 2007 with prices increasing 139%. However as the world fell into recession during 2008, dairy prices gave up all of these gains and by December 2008, prices were back to pre 2007 levels. This sharp decline in prices reflects a dramatic decline in demand meant which in turn lead to a large build-up in inventory at the beginning of 2009. Indeed this build up was significant enough the make cold storage space a scarce commodity around New Zealand.

What a difference a year makes! During 2009 whole milk prices grew strongly, reflecting increased confidence in the global economy. This has enabled Fonterra to not only increase its forecast payout to farmers but also significantly reduce its stock piled up in cool stores around New Zealand. For debt holders this very positive as it means less cash is needed to fund the inventory and as a result the business requires less debt. Consequently over the last year Fonterra has been able to successfully reduce its leverage (net debt/net debt + equity) from 58% to 52%.

The other major challenge faced by the businesses was how to modify its co-operative business structure to allow more (equity) capital to be raised. During 2009 Fonterra farmer shareholders agreed to a number of changes to

enable them to provide the business with more capital. Critically these changes did not alter the company's Co-operative structure. "Retaining the co-operative structure is a major plus for debt investors", says NZ Funds Principal, Mark Brooks. Fonterra sets the price it pays farmers for milk after determining its costs for the year. While this may not seem unusual, it is in stark contrast to most businesses. Other businesses have to pay their suppliers first. In Fonterra's case its suppliers are also its shareholders, so does not pay for its raw materials (milk) until all the businesses other cost have been paid. This is very positive for bond investors, as both interest and principal payments rank ahead of payments to farmers.

The combination of Fonterra's position as the world's largest dairy exporter and their co-operative structure provides the financial strength and flexibility that we look for as bond investors says NZ Funds Principal, Mark Brooks. At the same time with NZ Funds being the largest New Zealand owned fund manger, managing money for ordinary New Zealanders, is it important that we look to support NZ business - but only when the investment case stacks up. This is especially the case when that business accounts for around one quarter of New Zealand's export earnings.

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