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focus

Fonterra's Pivot: Trimming the Fat, Keeping the Cream

When Fonterra announced plans to divest its consumer brands business in May last year, many New Zealanders were surprised.

The portfolio — now dubbed Mainland Group — includes household staples and recognisable brands such as Anchor milk, Mainland cheese, Primo milk, and Fresh'n Fruity yoghurt. Some viewed the move as an admission by Fonterra of its failure to add value. However, we see it as a pragmatic recognition of where Fonterra excels.

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Mainland Group: Much broader than its New Zealand brands

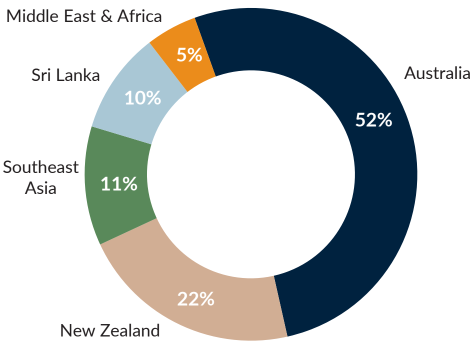
While most will associate Mainland Group with its strong local brands, these only represent a fraction of the company's operations. New Zealand accounts for just over 20% of revenue. The remainder comes from Australia (about 50%), Southeast Asia (10%), Sri Lanka (10%), and the Middle East/Africa (5%). Approximately two-thirds of revenue is generated from consumer-facing brands, with the rest from Foodservice (e.g. creams, cheeses, and butter for restaurants, bakeries, and cafés) and Ingredients (bulk dairy products sold to businesses).

MAINLAND GROUP IS MUCH MORE THAN NEW ZEALAND

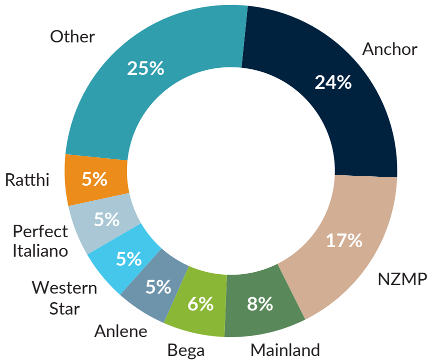
	Oceania		Southeast Asia	Sri Lanka	Middle East & Africa
	New Zealand	Australia			
Liquid milk[3]	Anchor, Simply Milk, Dairy Dale		Anchor, Anlene, Fernleaf, Anmum	Anchor	
Milk powder	Anchor, Anmum	nzmp	Anchor, Anlene, Fernleaf, Anmum	Anchor, Anlene, Rathi	Anchor, Anlene
Flavoured milk	Anchor, PRIMO		Anlene, Fernleaf, Anmum	Anchor	
Cheese	Mainland, Anchor FP, Galaxy, Kapiti, Perfect Italiano	Mainland, Anchor FP, Bega, nzmp, Perfect Italiano	Anchor, Mainland, Chesdale, Perfect Italiano	Anchor, Anchor FP Food Professionals	Anchor, الصقر FALCON
Butter & Spreads	Mainland, Anchor FP Food Professionals, Anchor, Country Soft	Mainland, Allowrie, Anchor	Anchor	Anchor, Anchor FP Food Professionals	Anchor
Cream	Anchor, Anchor FP Food Professionals	Anchor FP Food Professionals	Anchor	Anchor, Anchor FP Food Professionals	
Yoghurt	Anchor, Fresh'n Fruity, Kapiti, De Winkel		Anlene, Fernleaf, Anmum	Rathi, Anchor	

Source: Company reports

MAINLAND GROUP REVENUE MIX BY REGION



MAINLAND GROUP REVENUE MIX BY BRAND



Source: Company reports

Behind the well-known brands is a structurally low-margin business. Consumer dairy is commoditised and competitive, with limited pricing power and constrained ability to pass on rising costs.

Australia and Consumer: Long-term drags

Mainland includes the whole of Fonterra Australia — a full-service operation spanning milk collection, processing, and distribution. Sales channels include Consumer, Foodservice, and Ingredients. It contributes about 40% of Mainland's earnings but has consistently underperformed. Since Fonterra's entry to Australia in 2005, it has failed to build sufficient scale or profitability. Despite significant capital investment, growth has been sluggish and free cash flow persistently negative.

The Consumer segment tells a similar story. Weak earnings growth, low margins, and nearly $700 million in asset write-downs since 2012 underscore the challenges.

No hiding from poor returns on invested capital

Return on invested capital (ROIC) tells the story.

ROIC is a key financial metric that measures how effectively a company generates profit from the capital it invests in its business. In simple terms, it indicates how much profit a company earns for every dollar of invested capital. A company creates value for shareholders only when its ROIC exceeds its cost of capital — that is, what it pays to borrow money or raise equity.

Both Fonterra's Consumer and Australian businesses have delivered chronically low — and at times negative — returns. With $5 billion in revenue but only $200m in EBIT (earnings before interest and tax), Mainland Group's margins and returns lag not only global peers but also Fonterra's own Ingredients and Foodservice divisions.

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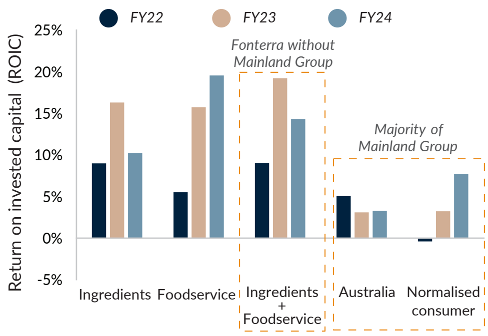
In contrast, we seek businesses with high – or at least cost-of-capital-beating – ROIC and the ability to defend those returns (referred to as an economic moat). Mainland does not tick these boxes.

FONTERRA CONSUMER AND AUSTRALIA RETURNS ON CAPITAL HAVE BEEN POOR



Source: Company reports

Why Mainland's performance has lagged

We believe the weak performance reflects:

- Absence of clear strategy
- Lack of global scale and fragmented operations, creating an elevated cost base
- No high margin 'hero' products
- Limited product breadth versus global peers
- Inefficient manufacturing (Fonterra's New Zealand sites process around 4x more milk than the Australian ones)
- Competitive global markets with limited pricing power
- Intense competition for milk supply in Australia

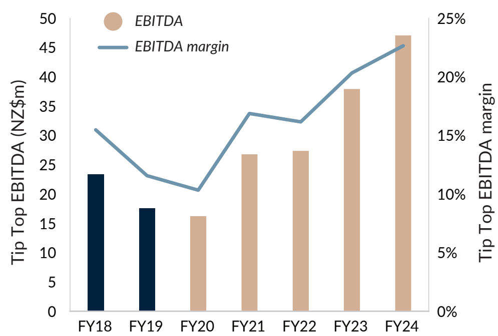
Put simply, Fonterra is not the highest-value owner of these assets. Capital tied up in these businesses could be better deployed elsewhere.

Where Fonterra succeeds

Some argue the Consumer and Australian businesses have lacked management focus and been under-resourced. But at its core, we believe this decision is about recognising that Fonterra's strength lies in global dairy ingredients – where it has scale, relationships, and operational expertise. Running multinational consumer brands is a different business – and one in which few New Zealand companies have succeeded.

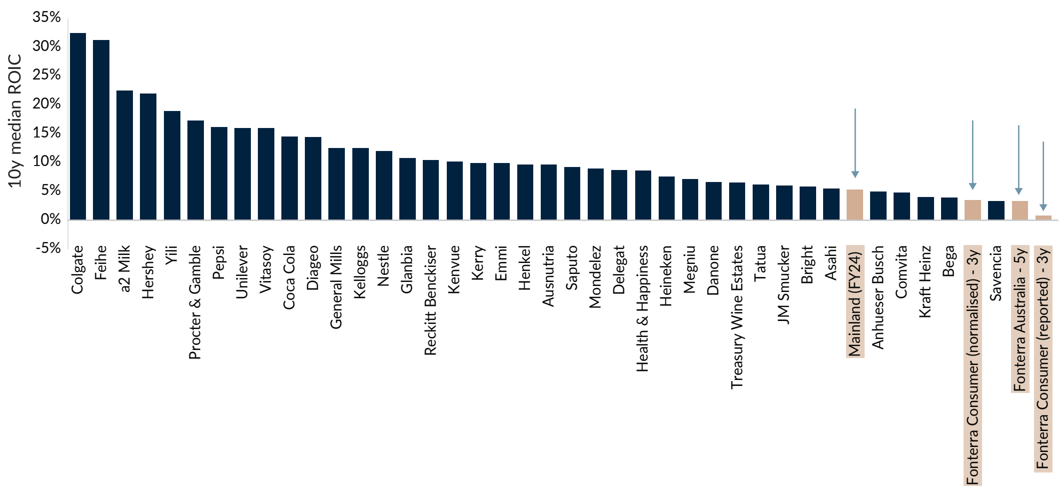
Fonterra's 2019 sale of Tip Top illustrates our point. Since being acquired by global ice cream group Froneri for $380 million, Tip Top's earnings have nearly tripled. Fonterra still supplies the ingredients – but Froneri unlocked the value. We expect a similar dynamic post-Mainland sale, although we anticipate it will be far more complex for new owners.

TIP TOP'S EARNINGS HAVE NEARLY TRIPLED



Source: New Zealand Companies Office. NB: Blue denotes period of Fonterra ownership. FY18/FY19 is July balance date, FY20-FY24 is December balance date. We have excluded impairments where required and earnings are shown on a pre-IFRS 16 basis to be like-for-like.

MAINLAND'S RETURNS COMPARED TO GLOBAL CONSUMER FOODS COMPANIES ARE UNDERWHELMING



Source: Company data, Refinitiv

...Fonterra's proposed divestment of Mainland may feel like waving the white flag, but we see it as a clear strategic reset...

Of course, the move isn't without risk. It concentrates Fonterra's earnings in fewer areas – especially China, where local milk supply is rising and demand is softening. It also reduces diversification and won't eliminate exposure to commodity price cycles. Fonterra will remain a price taker in many of its markets. However, it has clearly recognised and acknowledged these trade-offs.

What's Mainland worth?

Fonterra is running a 'dual-track' process: a potential industry sale or an initial public offering (IPO) on the share market. Both options remain live, but an industry sale appears more likely at this stage.

We estimate Mainland's IPO value at around $2.5 to $3.0 billion (or $1.50 to $1.85 per Fonterra share). A strategic buyer may be willing to pay a premium if cost synergies are achievable and they take a positive view on the turnaround potential (as seen with Tip Top). However, the fragmented nature of the assets and Australia's structural issues could be barriers.

Regardless of the route taken, a successful exit would enable capital to be returned to shareholders and allow management to refocus on higher-return operations.

Not a white flag – a better focus

Fonterra's multi-decade struggle to 'add value' wasn't for lack of effort. But value creation is not about effort or market share – it's about capital discipline and knowing where to focus.

Mainland was only 10% to 15% of Fonterra's earnings last year. What's left of Fonterra will be a $15 to $20 billion revenue business, servicing global Ingredients and Foodservice customers. Ingredients is the main driver – Fonterra sells to over 130 countries globally, with key products including dairy fats, cheeses, milk powders, proteins, and specialty ingredients, generally sold in bulk form. Foodservice is smaller, but Fonterra has a presence in 50 countries and is one of the world's leading foodservice brands, with key customers including restaurants, bakers, caterers, commercial kitchens, and cafés.

Fonterra's proposed divestment of Mainland may feel like waving the white flag, but we see it as a clear strategic reset. Fonterra excels at milk processing – not at managing brands. Mainland may be iconic, but it does not belong at the heart of the co-op's future.

If at any time you want to discuss investment options and opportunities, your Forsyth Barr Investment Adviser is available to provide you advice and assistance.

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