Senate Inquiry into the Dairy Industry

Introduction

This submission is made by Michael Stapleton. My first career was as a banker, during which time I spent four years between 1999 and 2003 lending money to, and analysing the financial and operating information of large businesses involved in the Food, Beverages and Agribusiness sectors of Australia and New Zealand.

Amongst the clients whose operations and financial information I analysed at that time were Ricegrowers' Co-Operative (also known as SunRice), GrainCorp, Australian co-Operative Foods (also known as Dairy Farmers) and Fonterra Co-operative. These businesses share common traits with Murray Goulburn ("MG") in that they were either co-operative businesses, used pool pricing as a means of determining seasonal payments to their suppliers or both.

My current career is as a Virtual CFO, operating my own practice, helping owners of small and medium size businesses use their financial information to grow their businesses.

I am also a founding member of the Association of Virtual CFOs. This is a relatively young Association, formed in April 2016 with the aims of:

- Educating the small and medium size business market about the Who, What, Why and How of a Virtual CFO; and
- Bringing together a community of largely isolated, sole practitioner Virtual CFOs to share knowledge and experience.

I have a B.Comm with a Finance major from UNSW, a Diploma in Applied Finance and Investment from the Securities Institute of Australia (now Kaplan) and have completed the CPA programme.

Terms of Reference A: Legality of Retrospective Elements of Milk Contracts

One of the quirks of Murray Goulburn's business model is that they pay their milk supplier members on the basis of a pool payment system. It is the use of this system that embodies the retrospective element of the contract.

Pool payments are common in agri co-operatives and are a way of connecting payments to the commodity prices for a particular season (for grains, as an example) or a particular year (for milk, as an example).

Under the pool payment system the supplier members of a Co-op receive what is left over once the cost of production and cost to run the business has been deducted from the revenue of the business.

In effect, this means the final pool payment and profitability of the Co-op is worked out in reverse. Under this model, a Co-op should never make a loss, which makes sense, as the supplier members are usually also the owners of the business and the variability in their returns under the pool payment system is akin to the variability in returns to owners of other legal entities (companies etc).

In practice, an indicative pool price (in MG's case - the Farmgate Milk Price – FMP) is set at the start of each year (or season) and that price is adjusted as the season progresses and the interplay of sales volumes and commodity prices is realised.

Usually, the indicative pool price is set conservatively and supplier expectations managed by delivery of a final realised price somewhat better than the initial pool price. The retrospective element is rarely used and when it is used it is because of a major, unforeseen shift in the supply of and demand for the particular commodity.

My point is that pool pricing is a well understood and established practice amongst agribusinesses. There is ample precedent for changes to the pool price to impact on final returns to farmer suppliers, but rarely have there been such a shocking change, so late in a season, with so little warning and without an underlying change[1] during the season of the supply and demand characteristics for milk and its derivative products (powders etc).

Terms of Reference B: The Behaviour of Murray Goulburn

The behaviour of Murray Goulburn has been deplorable. This statement is self-evident considering the number of farmer suppliers who have left the co-op since April 2016 – about 10% left in the period to August, according to MG's own comments (see Q.13 at the following link):

http://www.mgc.com.au/media/40793/Supplier-Information-Sessions-Additional-post-session-QA-summary-3-web-final.pdf

I believe there are two significant factors underpinning the behaviour of Murray Goulburn

Factor 1: An Unrealistically Aggressive Forecast

My opinion is that the board knew, or ought to have known, that the forecast for FY16 was unachievable based on their Q1 outcomes.

Consider the following assumptions, which underpinned MG's FY16 forecast[2]:

- Milk intake of 3.65 billion litres.
- Revenue of $3.3 billion.
- FMP of $6.01/kg of milk solids.
- Commodity prices to increase over those prevailing at the date of the PDS, skewed to the 2nd half of FY16. MG expected to make a 3 to 6% premium on dairy commodity prices above the Global Dairy Trade benchmark indicator.
- Average foreign exchange rate of US$0.76.
- Value Added product sales to increase to 74% of Total Sales (FY16).

From these assumptions it can be seen that MG's FY16 forecast Revenue/Litre of Milk received is $0.90c. The historic comparisons provided in the PDS, plus prior financial reports, shows historic

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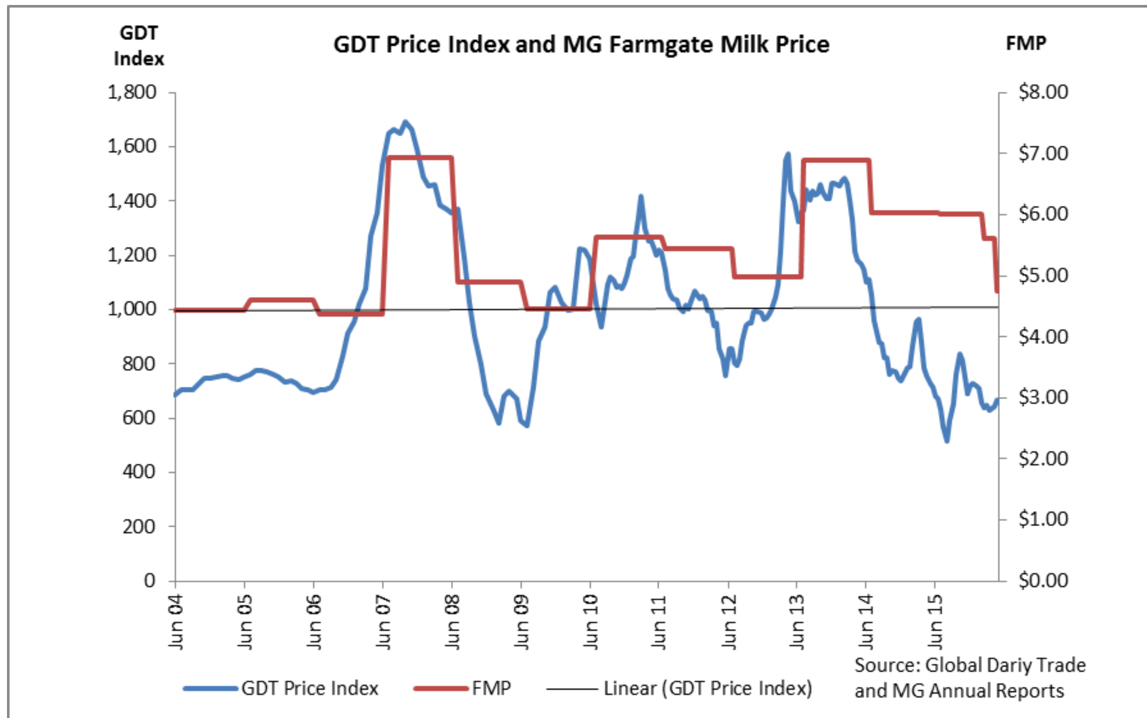
[1] EU milk quotas (a supply side impact) ceased from 31 March 2015, three months before the start of FY16, hence sufficient time to take account of this in the FY16 forecast and associated FMP. The Russian embargo (a demand side impact) had been in place since August 2014.

[2] MG Unit Trust Product Disclosure Statement of 29 May 2016.

Revenue/Litre of Milk of $0.80c Revenue/litre in FY15, and an average of $0.81c Revenue/litre over the period between FY12 to FY15.

Now, consider the following graph:



The FMP tracks the movements in the GDT Index of international dairy prices quite closely until December 2013. The gap between FMP and international dairy price index then widens precipitously, until Feb 16 and April 16, when real world conditions could no longer be ignored.

The gap between FY16 FMP and the dairy commodity price index at the time it was set indicates that the FY16 forecast embodied very aggressive assumptions.

The board of MG would have known the key drivers of the budget and hence should have understood whether the business was on track to meet its plans. For example, they could have tracked the:

- Volume of milk intake each month.
- Revenue/litre of milk each month.
- Product mix each month.
- USD exchange rate.
- Commodity price index.

The movement in these measures would have informed the board as to whether the earnings forecast remained underpinned by valid assumptions, or whether it needed reviewing and possibly changing.

My opinion, based on the difference between the Commodity Price Index and FMP is that the board should have been asking serious questions about the achievability of the forecast by the time Q1FY16 was finished. The stretch to fill the 10c increase in Revenue/Litre would have been widening quickly and moving out of reach by that time.

Factor 2: Not Implementing a One off Deviation from the Profit Sharing Mechanism

A consequence of not implementing the available one off deviation from the Profit Sharing Mechanism[3] has been that the farmer suppliers to MG have taken the brunt of the pain from the aggressive forecast outlined in Factor 1.

Before I continue it would be helpful to consider how a co-operative using a pool payment system operates in terms of determining its profit and loss. The flexibility that MG has in determining its profit underpins the Profit Sharing Mechanism. An understanding of this flexibility is germane to understanding the options that were open to MG to lessen the impact of missing its forecast and over-estimating its FMP on its suppliers.

Here is a snapshot of MG's profit and loss statement from their unaudited, year-end announcement to the ASX on 24 August 2016:

	FY16	**FY15**
	$m	**$m**
Sales	**$2,778**	**$2,872**
Cost of Goods Sold	***$2,367***	***$2,508***
Gross Profit	**$411**	**$364**
Gross Margin	**14.8%**	**12.7%**
Other Income	$19	$1
Operating Costs	$372	$342
Operating Costs / Sales	**13.4%**	**11.9%**
Net Profit before Tax	**$58**	**$23**
Milk Received (Litres)	3,491,000,000	3,580,000,000
Sales / Litre	$0.80	$0.80
FMP	$4.80	$6.02

You will see there has been no change to the Sales per Litre return at 80c, but a better Gross Profit and Gross Margin in FY16, and a business that slashed its payment to suppliers, from $6.02 in FY15 to $4.80 in FY16.

On face value, this outcome does not match the travails of this business in the 2nd half of FY16.

[3] MG moved to a hybrid business model in August 2015 when it issued units in a unit trust to external investors as a means of raising new capital. The Profit Sharing Mechanism was intended to "align" the interests of supplier members and unit holders. Under the Profit Sharing Mechanism MG must record a Pre-Tax Profit of between **5% and 10.7%** of the Distributable Milk Pool.

This is because the pool payment system affords MG considerable flexibility when declaring a profit. This is due to the pool payment being a component of the Cost of Goods Sold for Murray Goulburn – it represents the Cost of Raw Materials to Murray Goulburn.

The other component of their Cost of Goods Sold is the Cost of Production – drying milk into powder, turning it into cheese, pasteurising and homogenising for drinking milk etc.

The pool payment made by Murray Goulburn is disclosed in the notes to their announcement. When deducted from the Cost of Goods Sold figure what remains is the Cost of Production.

Here is the snapshot of their profit and loss statement updated for this information:

	FY16	FY15
	$m	$m
Sales	**$2,778**	**$2,872**
Cost of Raw Material	*$1,098*	*$1,357*
Cost of Production	*$1,268*	*$1,151*
Cost of Goods Sold	***$2,367***	***$2,508***
Gross Profit	**$411**	**$364**
Cost of Raw Materials / Sales	*39.5%*	*47.3%*
Cost of Production / Sales	*45.7%*	*40.1%*
Gross Margin	**14.8%**	**12.7%**
Other Income	$19	$1
Operating Costs	$372	$342
Operating Costs / Sales	**13.4%**	**11.9%**
Net Profit before Tax	**$58**	**$23**
Milk Received (Litres)	3,491,000,000	3,580,000,000
Sales / Litre	$0.80	$0.80
FMP	$4.80	$6.02

We know about the supplier payment issues and that is obvious when you look at the change in the Cost of Raw Materials relative to Sales – reduced from 47.3% to 39.5%.

But, what has not been so obvious is the rising Cost of Production in FY16. You can see it is 45.7% of Sales in FY16, a big increase from FY15 when it was 40.1% of Sales. So, impacting on the business is not just “unexpectedly” lower commodity prices, but also a blow out in the cost of production.

Now, let’s consider the positon had Murray Goulburn not declared the “overpayment” of this year’s pool price would be treated as a loan to the supplier members, to be repaid over three years (through deductions from future pool outcomes).

To do this, they have taken $183.3m of payments made to their supplier members out of their Cost of Raw Materials and capitalised it on their balance sheet as a loan.

Let's take a look at their position if they had not taken that action:

	FY16 $m Adjusted	FY16 $m
Sales	**$2,778**	**$2,778**
Cost of Raw Material	*$1,098*	*$1,098*
Overpayment for Raw Material	***$183***	
Adjusted Cost of Raw Material	***$1,282***	
Cost of Production	*$1,268*	*$1,268*
Cost of Goods Sold	**$2,550**	**$2,367**
Gross Profit	**$228**	**$411**
Cost of Raw Materials / Sales	*46.1%*	*39.5%*
Cost of Production / Sales	*45.7%*	*45.7%*
Gross Margin	**8.2%**	**14.8%**
Other Income	$19	$19
Operating Costs	$372	$372
Operating Costs / Sales	**13.4%**	**13.4%**
Net Profit before Tax	**(-$126)**	**$58**
Milk Received (Litres)	3,491,000,000	3,491,000,000
Sales / Litre	$0.80	$0.80
FMP		$4.80

You can see from the FY16 Adjusted column in the table above that classifying the $183.3m as a payment to suppliers (not as a loan to supplies) would have increased the Cost of Raw Materials to $1,282m and lowered Murray Goulburn's announced Gross Profit to $228m.

The consequences would have continued to flow down their Profit and Loss statement ultimately manifesting as a loss of $126m. Quite a different position to that announced, and more in line with the issues faced by the business.

Remember, the Net Profit of Murray Goulburn is essentially worked out in reverse, by adjusting the pool payment. The choice made by Murray Goulburn meant it could announce a profit in line with its Profit Sharing Mechanism and pay a dividend to its supplier members and its unitholders.

However, the MG board had the option of implementing a one off deviation from the Profit Sharing Mechanism. This deviation is possible in certain abnormal circumstances.

The definition of abnormal is *deviating from what is normal or usual, typically in a way that is undesirable or worrying*. I think FY16 meets this definition[4].

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[4] MG have met or exceeded the FMP in 62 out of 65 years of trading. Clearly, not meeting or exceeding FMP is not normal or usual.

Here is what the PDS says about the one off deviation from the Profit Sharing Mechanism:

"…in certain abnormal circumstances, the Board of Murray Goulburn may decide that, for the benefit of all stakeholders (including Suppliers (both as suppliers of milk and as Shareholders) and Unitholders), the Profit Sharing Mechanism should be deviated from when allocating the Milk Pool to Milk Payments, income tax and NPAT.

Examples of abnormal circumstances that may give rise to a departure from the Profit Sharing Mechanism may include extreme prolonged drought conditions, prolonged levels of materially increased competition for milk supply **or other circumstances** (my emphasis) determined with the unanimous consent of the Special Directors to warrant deviation from the Profit Sharing Mechanism in order **to protect Murray Goulburn's milk supply and profitability and support its Supplier base** (my emphasis).

Any departures from the Profit Sharing Mechanism require approval by a majority of the Board of Murray Goulburn and by each of the Supplier Directors. A decision to deviate from the Profit Sharing Mechanism must be considered by the Special Directors to be in the interests of Suppliers (both as suppliers of milk and as Shareholders) and Unitholders as a whole.

In addition, in the event of a proposed departure from the Profit Sharing Mechanism, the Special Directors of Murray Goulburn would be required to ensure that any such departure be supported by an opinion, provided by an independent expert, that the departure is in the interests of Suppliers (as suppliers of milk and as Shareholders) and Unitholders.

I cannot imagine a more abnormal "other circumstance" than the FY16 year and a need for MG to protect their milk supply and profitability and support its Supplier base. The exodus of suppliers from MG since the revision to the FMP in April is tangible evidence that Suppliers do not believe their interests have been considered adequately.

Conclusion

An unrealistically aggressive forecast for FY16 is at the heart of the impact on farmer suppliers. The departure from the normal approach of setting a conservative FMP is highlighted in the chart of Global Dairy Index and FMP and is perplexing.

A failure to address this unrealistic forecast when actual results would have made it clear the task was getting more difficult has compounded the issue.

If the board of MG had recognised in a timely manner that the uplift was not going to be met (because of commodity price levels, and higher cost of production) then they could have declared a one off deviation from the profit sharing mechanism prior to an interim dividend being paid in Feb 16.

This would have given them the flexibility to reduce a $183m clawback/revision to a $126m clawback/revision. The difference of $57m could then have flowed in its entirety to the suppliers, easing their situation.

It is clear that the board chose the interests of relatively new unitholder to the business over the interests of their long term owners and core constituency, the farmer/suppliers.