BAY MILK PRODUCTS 'TACKLES' THE INDUSTRY 'GIANT'

THE BAY MILK PRODUCTS - AND NEW ZEALAND DAIRY GROUP MERGER STORY

C.C.HAMMOND
JULY 1997

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An Industry Poised for Change

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July 1997

1.0 Executive Summary

In the 1990's the Diary Industry entered into an area of rapid change, and legislative reviews that altered the relationship between the NZ DAIRY BOARD and the Dairy Companies.

BAY MILK PRODUCTS (BMP) endeavoured to manage Industry change in a positive and constructive manner, but soon realised that with only minority industry support it had little chance of achieving the required objectives. This prompted BMP to look at available options and plan for what might be a very different future.

Following extensive studies, consultations, and debates, a merger of operations between NZ Dairy Group and BMP was widely accepted as the best and most practical option to secure the best shareholder long term interests.

The merger negotiations and their implementation achieved a very high level of support and good will on both sides which was unusual historically in dairy company mergers. Merger benefits were real, quantifiable, and described as 'fair' to both parties on both a tangible and intangible basis.

Following the receipt of major shareholder support for a merger, BMP ceased to exist as of 1 June 1997, exactly one decade after a major earthquake devastated its operations and the long costly rebuilding programme had began.

The future combined company will create a co-operative that is perceived to be efficient, cost effective, and able to maximise shareholder returns. The strategic intent of the new company is to continually outperform all other New Zealand dairy companies in present and future years.

The questions that remains in peoples minds are *'will the merger benefits be achieved' and 'what is the long term future of the Edgecumbe site? Will it prosper and grow or die like so many Dairy companies before in rationalisation history?'*

C.C. HAMMOND
July 1997

2.0 INTRODUCTION AND BACKGROUND

In 1994, I joined the Board of Directors of BAY MILK PRODUCTS (BMP), as a farmer representative. This was an interesting time to enter the area of Dairy Industry politics because major changes were being discussed and debated amongst the Diary Company leaders.

BMP was actively involved in Industry politics and the current debate, soon realising it must consider its options for a long term secure future. The BMP philosophy was to manage the changes rather than resist and become alienated from the Industry.

3.0 OBJECTIVES OF REPORT

The Objectives of this report are designed to:

1) Identify and discuss the changes in the NZ Dairy Industry that led BMP to consider its options for the future.

2) Look in detail at the options available to BMP to secure shareholders long term best interests.

3) Outline the merger proposal and the associated perceived benefits of merging NZ Diary Group and BMP.

4) Record all of the above as a Historical Record for future reference.

5) Take the opportunity to put all relevant information accumulated into one chronological report.

4.0 BAY MILK PRODUCTS PROFILE

BMP was formed in December 1985, as a result of the merger of three Bay of Plenty Co-operative Diary Companies.

The company's MISSION:

> ***TO BE THE WORLD'S LEADING PRODUCER OF MILK BASED SPECIALISED FOOD INGREDIENTS. TO CONTINUALLY MAXIMISE THE INCOME WE EARN FOR OUR SHAREHOLDER SUPPLIERS.'***

The company has 890 shareholders within an 80 km range of Edgecumbe with an average herd size of 180 cows (totalling 166,000 cows). These farms supply BMP with 536 million litres of whole milk during the dairy season, including 25.8 million kgs of milk fat and 19 million kg of protein.

The company made a wide range of products from its three major operations of cream production, protein products, whey products, plus the food ingredients from the TePuke site. The company had been highlighted in the Industry for the development and commercial production of spreadable butter, made possible through the product development centres at BMP's site.

BMP has auxiliary sites at TePuke for food ingredient production, Mt. Maunganui (Intermilk) for liquid fresh milk and consumer products. The company also manages the Industry owned Coolstore International Ltd on the Tauranga wharf and a retail outlet called RIVERSLEA in Edgecumbe. All contribute towards shareholder revenue.

In 1987 a major earthquake hit the Bay of Plenty Region devastating the Edgecumbe Factory; subsequent rebuilding was a major achievement in the company's history.

5.0 MAIN REPORT - PART I

In December 1994, BAY MILK PRODUCTS (BMP) Directors met with Warren Larsen, Chief Executive of the New Zealand Dairy Board, to discuss Industry decisions and events that were impacting negatively on BMP's day to day, and future business operations. BMP's major area of concern was the payment system and how it was being skewed to favour the larger players leaving the smaller companies, fewer and restricted options.

BMP's Directors concluded from the meeting that the Dairy Industry was poised for major changes and they must consider options and plans for the long term interest and security of the Company's shareholders.

Some possible options:

1) Work to change the system so that the distribution of the pool is more independent of the larger company's influence (our current strategy).

2) Increase the proportion of activity outside the pool ie: local markets, exports under license.

3) Become part of a larger existing player

4) Promote the formation of a new entity of sufficient size to secure the balance of power.

BMP was not the only Company revising its future and options. The largest company in the Industry, **New Zealand Co-operative Dairy Company (NZCDC)** was as a consequence of the ongoing investment funding requirements, demanding security of ownership of the NZ DAIRY BOARD.

This "Corporatisation" idea of NZCDC was initially resisted by the NZ DAIRY BOARD and the rest of the Industry on the grounds that ownership was secure and a conventional share structure was actually a danger to the co-operative nature of the Industry. However, NZCDC intimated that its support for further industry investment in the NZ DAIRY BOARD was conditional upon security of ownership being achieved, as was their relinquishment of the ANCHOR brand to the total industry.

The NZ DAIRY BOARD subsequently changed its stance on the ownership issue and sponsored the '*structural package*' through a very intensive period of industry debate and scrutiny.

6.0 THE DAIRY BOARD AMENDMENT ACT *(Structural Package)*

The initial issues that the *structural package* was designed to resolve:

1) Clarify and secure ownership of the NZ DAIRY BOARD through implementation of a conventional ownership structure.

2) Capital provision on an equitable basis to fund the expected high level of milk growth over the next 10 years.

3) Protection of the investment in our lead brands by securing full NZ DAIRY BOARD ownership of them on a permanent basis.

4) That the Board remains an ongoing concern in the future by adopting dissolution provisions that will ensure the Board remains in the event the Board's statutory powers are revoked.

6.1 THE BENEFITS OF THE *STRUCTURAL PACKAGE.*

The benefits of the *structural package* were marketed as tangible and huge to the Industry.

1) BRANDS

Transferring the ANCHER, FERNLEAF and MAINLAND Brand Companies to the Board is worth hundreds of millions of dollars.
The reasons:

- The brands are the single most valuable asset of the Board
- Under the current trust deeds, the brands would be rendered worthless to all companies over a relatively short period of time.
- Significant investment in the brands will be necessary over the next decade.

  Based simply on current programmes, the required investment will be in the order of $2 billion over 10 years.

- In light of the foregoing, the NZ DAIRY BOARD will have to consider the continued use of the brands if their ownership by the Board is not absolute.

2) **DISSOLUTION**

Failure to provide for the Board to continue as an ongoing entity on dissolution and to address the tax issues involved could cost shareholders dearly. The Board currently has $ 1.45 billion of farmers money intrusted to it. This figure is likely to grow significantly over the next decade. This being the case, it is incumbent on the Board to ensure these assets are protected as securely as possible for the benefit of all Shareholders of the Board.

3) **DILUTION**

The current Act means that for every 1% movement in milk supply between dairy companies there is a transfer of wealth of approximately 15 million dollars at no cost.

4) **GROWTH**

Based on a growth in milk supply of 3.5% per year, existing milk is funding new milk to the extent of approximately 35 million annually.

5) **STATUTORY POWERS**

The package deals with some key issues of national policy. Failure to address these issues may cause the Board's statutory powers to be reviewed earlier than otherwise would be the case. Other producer boards may be suffering from this problem now. The loss of the Board's statutory powers is also potentially worth hundreds of millions of dollars, not just once but annually.

6.2 BMP VIEWS ON THE DAIRY BOARD AMENDMENT ACT (*Structural Package*) AND LIKELY EFFECTS ON THE COMPANY'S OPERATIONS AND FUTURE

The BMP Board were uncomfortable with the initial proposition by NZCDC and whilst naturally agreeing to have the various matters investigated, the BMP Board has expressed fundamental concerns every step of the way.

BMP's over riding concern with the package, as it stands, is the creation of shares in the NZ DAIRY BOARD and the distribution of those shares to the Dairy Companies. This in BMP Board's opinion, was a significant step to a stronger autonomy and a less integrated industry.

The issue of Diary Board shares to the Companies is an attempt to 'co-operatise' the Board through Company Shareholding. The Board is not a co-operative at present, it is a statutory body. The BMP Board believed that the NZ DAIRY BOARD would not operate successfully as a co-operative with the companies as the shareholders, for two basic and fundamental reasons.

Firstly, two of the companies would control well over 50% of the shares and easily be able to dominate the other shareholders.

Secondly, Co-operatives only work well where members receive or supply the same product or service. The Dairy Companies work well because they take one product, milk. As soon as a further product or service is introduced the transfer pricing or 'cake sharing' arguments start, often resulting in the splitting of the co-operative itself.

The NZ DAIRY BOARD purchases literally hundreds of different products. The BMP Board could not see how a minority company could contemplate being a shareholder of a successor organisation to the NZ DAIRY BOARD which was a co-operative where:

i) The co-operative was controlled by one or two major shareholders.

ii) The co-operative purchased different products from different members and rebated its profit by way of product price.

iii) The minority company was dependent on the successor organisation for a significant proportion of its revenue.

BMP Directors held a strong view that a better solution to company Shareholding in the NZ DAIRY BOARD would be direct Shareholding by the 14,000 individual dairy farmers. Ownership and control would then be directly in the hands of the people who own and rely on the Business. This proposal never gained wide-spread industry support by the companies and was unfortunately never allowed to be debated amongst the individual farmers. BMP having covered the reasons for its opposition to the package and suggestion for alterations, were conscious of the fact that a majority of Dairy Companies either actively supported the proposal or at least were agreeable to it proceeding. It was also noted that all Diary Board Directors were in favour of the package and therefore the company had to consider its position should legislation be drafted as per the current proposal.

7.0 BMP BOARD CONSIDERS OPTIONS FOR THE FUTURE

On dissolution of the NZ DAIRY BOARD, BMP could either form part of an ongoing organisation, or the company would be forced to take its share of the Boards assets and operate independently.

The status quo of a stand alone business based on the established type of co-operative was not going to be a viable option for the long term future in a changing industry. In May 1995 the BMP Board met with a vision to develop a long term strategic plan of various options available to the company that would secure the long term interests of its shareholders.

Three options were developed with the idea to progress all three until one surfaced as the most viable and practical option that would gain majority acceptance.

8.0 OPTION ONE

1. OBJECTIVE:

Take the opportunity presented by the current NZ DAIRY BOARD restructuring proposal to form a fully integrated NZ Dairy Industry Export Company.

2. ADVANTAGES OF ONE COMPANY

Functionally, the *one company option* would cement in place the role that the NZ DAIRY BOARD currently has, but allow the one structure to integrate manufacturing with marketing. The key advantage would be the ability to form and carry out a single industry ~~vision~~/mission and the consequent improvement in performance that would result.

Specifically, this structure would provide overall control of manufacturing to allow individual production at the best location from a quality and cost point of view. Actual costs, rather than theoretical, would be available for decision making. A single information system would develop resulting in administration and processing cost savings.

The response time from milk to customer would be significantly shortened with the removal of the negotiation phase between marketing and manufacturing. Technical support could be fully integrated from processing to the market place. Benchmarking actual costs would replace cost modelling of theoretical costs. Industry definitions of quality for the purposes of pool sharing could be dispensed with in favour of customer determined quality parameters, saving considerable ~~sums.~~ costs.

3. STRATEGY TO ACHIEVE A SINGLE COMPANY

In order to achieve a single company, an agreement from all parties, reluctant or otherwise, would be required. Suggested strategy would be as follows:

- Gain support of a group of other companies for the proposal.

- Prepare a description of the proposal and undertake a preliminary estimation of the financial benefits to be gained.

- Inform NZ DAIRY BOARD that the integration proposal is supported by a group of companies and that they no longer support the current restructuring proposal unless it is amended to achieve full integration. Request a full investigation into the changes proposed

- Visit all other companies and present the proposal.

- Prepare the Key Points for shareholder appraisal:
  - fully integrated industry
  - shares held directly by farmers
  - efficiencies gained calculated to return extra payout to farmers
  - politically immune structure
  - ownership of all assets secured in farmer's hands
  - full farmer control maintained.

- Prepare material demonstrations non-single seller and non co-operative aspects of the current structure and the likely effects of the current restructuring proposal.

- Lobby farming opinion makers and politicians

- Publicly debate if necessary.

4. <u>POSSIBLE OUTCOMES</u>

- A *single company* industry is achieved with the full statutory powers of the NZ DAIRY BOARD maintained, allowing small niche independents to export.
- A *single large company* is achieved with some export activity remaining outside the company operating under export licence and a sunset clause on the statutory powers of the NZ DAIRY BOARD expiring after five years.
- The proposal strongly opposed by NZ Co-operative Dairy Company and Kiwi. An entrenched position developed where neither proposal is progressed.

- Support for *one company* withers as insurmountable hurdles appear, forcing the original group to reconsider and support the current proposal.

5. CONCLUSION

The *one company* proposal was rapidly approaching the 'now or never'. It would be possible, if strong and unwavering support is gained from an initial group of companies representing at least 30% of the milk supply.

C.C. HAMMOND
July 1997

9.0 OPTION TWO

1. OBJECTIVE:

Take the opportunity presented by the NZ DAIRY BOARD proposal to approach NZCDC and negotiate a merger of the two companies.

2. ADVANTAGES OF A MERGER

A merger of the Waikato and Bay of Plenty farmers into one company would form an organisation covering half of the nation's milk production and comprising nearly 7,000 suppliers. The Company would have a reasonably compact collection area with a good spread of powder, cheese protein and cream products. NZCDC already has a dominant presence in the local market (and some export) for consumer products whilst BMP would bring specialised cream and protein technology plus formulated products.

Both companies have similar performances and balance sheet strengths at present. Each has something to offer the other in terms of the whole being greater than the parts. The merger would not result in large processing cost reductions as there are no dual collections costs. However, there would be some rationalisation and cost savings.

The merged company would wield considerable industry influence over the NZ DAIRY BOARD and other companies having effectively, the determining vote on an industry issue.

3. STRATEGY TO ACHIEVE A MERGER

NZCDC wished to have the full and undisputed ownership of NZ DAIRY BOARD in company hands by way of a share structure in NZ DAIRY BOARD. The transformation of NZ DAIRY BOARD from a statutory body into effectively a co-operative was opposed by BMP due to the dominance that larger players would most likely have in the new structure.

All other companies, except Tatua and East Tamaki, had indicated support for the proposal. Should BMP oppose, the proposal would most likely fail. Continuing support will see it succeed. BMP has the key to a door which NZCDC most definitely wishes to open.

The strategy would therefore be to enter discussions indicating an intention to merge on favourable terms or to block the restructuring proposal to otherwise protect our shareholders interest.

The timing was already tight, however the proposed timing on the restructure was also tight and unlikely to be met. Both processes could proceed in parallel.

4. REACTION OF BMP SHAREHOLDERS

A large majority of BMP shareholders would be expected to support the proposal as long as no significant differentials were involved and all current suppliers were granted on ongoing supply rights. There would be concerns about Bay of Plenty representation and being swallowed by a larger organisation but, these could be overcome.

5. REACTION OF WAIKATO SHAREHOLDERS

A reasonable number of NZCDC shareholders are disaffected already believing they had no effective choice of supply and had not seen the rewards of the last merger. The majority, however, were likely to support the continuing growth of their company by way of merger, seeing it as somewhat inevitable and a natural step to further integration of the Industry. BMP was viewed with a certain degree of respect for its industry technological leadership and tenacity. A merger with BMP would be viewed more favourable than any other by the shareholders of NZCDC.

The Reporoa site has a limited life and therefore the Edgecumbe site would be seen as a logical fifth mega site in the overall rationalisation of NZCDC. Overall, NZCDC shareholders would be expected to support the merger.

6. OTHER COMPANY REACTION

All other companies would be expected to oppose the merger as a step towards dominance of the Industry by one party. BMP was often the leading opposition to NZCDC in Industry forums and this loss, along with a larger NZCDC, would give further dominance in the Industry by one party. Some companies could lobby against the proposal by submissions to the commerce commission.

7. COMMERCE COMMISSION

The Commerce Commission is liable to take considerable cognisance from the experience of the Waikato and NZCDC merger, where their ruling was overturned in the High Court.

8. NEW ZEALAND DAIRY BOARD REACTION

The NZ DAIRY BOARD would be expected to have no official position on the merger. However, it would not be favoured due to the increased influence that the merged company would have on the total industry. NZ DAIRY BOARD will take no definite action to prevent the merger.

9. POSSIBLE OUTCOMES

- **Merger Successful**

  The merger is successfully completed in parallel with the NZ DAIRY BOARD restructuring proposal. The NZCDC becomes the undisputed dominant player within the NZ Dairy Industry and has more control of the actions of the NZ DAIRY BOARD. Other companies whilst disadvantaged, stay within the single seller structure due to a lack of viable alternations.

- **Merger Successful**

  The merger is successful, however, other companies remove support for the restructuring package and lobby government for exit clauses due to the obvious dominance of NZCDC. The Act is revised with sunset clauses on the statutory powers. The merger has a breakdown of the single seller. However, the large company would compete well in the international market place and incorporate much of the NZ DAIRY BOARD's current operations.

- **Merger Unsuccessful**

  The merger proposal is rejected by NZCDC (after discussion with their advisers) as unlikely to provide substantial benefits to their shareholders. BMP reverts to one of its other options having lost some time in the process.

10. CONCLUSION

It was considered that a merger could be achieved if pursued strongly by BMP at the time. The merger could result in the somewhat earlier demise of the single seller than otherwise would be the case.

10.0 OPTION THREE

1. OBJECTIVE

Actively prepare for disintegration of single seller with BMP moving to international marketing of its own product.

2. COMPETITIVE POSITION

The key question was whether BMP's current product mix would be competitive compared to other NZ dairy companies in the event that there was not the single seller option.

Each product group, ie butter, cheese, powders and casein has a staircase of returns from a NZ context. This is unusual and important to recognise. Our competitors in Europe and USA have very similar returns from each product group and shift production to ensure this is retained.

3. CONCLUSION

BMP's product mix could return the industry average payout on base specification products sold to bulk commodity users basis as long as:

(i) The company received a fair proportionate share of the EU butter quota and the Japanese PEF quota sufficient to equal the average milk solids return achieved on all butter and cheese quotas ie: because the company does not manufacture cheese we would need more than 6.7% of the butter quota to account for our share of the cheese quotas which we did not take up.

This could be achieved if the NZ DAIRY BOARD continued to administer the quota markets under a single seller arrangement and distributed the returns on a milk solids basis or all quotas were proportionately allocated to companies who could then trade them to each other to achieve the desired balance.

THE NECESSARY STEPS

Current restructuring proposal:

- The opportunity must be taken now to negotiate in the changes to the Act, especially the terms and conditions of exit should a company wish to do so at a future date. The Act may be specific, or recognise the ability of the NZ DAIRY BOARD to have an agreement with companies to exit.

The exit provisions would need to cover:

⇨ The share and valuation of the Assets of the NZ DAIRY BOARD.
⇨ The share and ongoing administration of the quota, markets.
⇨ The ongoing nature of the NZ DAIRY BOARD and the effect on its statutory powers if any.
⇨ The conditions under which a company could activate the exit provision and those under which the Board must comply, if any.

Tactics to Gain Exit Provision

Join forces with East Tamaki and Tatua, and strongly lobby NZ DAIRY BOARD for development and inclusion of exit provision. Failing this, make strong representation at the select committee stage on the basis that:

a) the wish to continue with single seller but must have exit provision to protect minorities from detrimental dominance.

b) exit must be at the discretion of the affected party and at a fair value.

c) exit provision must provide for proportional access to quota markets.

d) current parties have shown propensity to dominate in the past.

e) NZ DAIRY BOARD may stifle ability to gain rewards for innovation by not granting export licences.

POSSIBLE OUTCOMES

1) Exit provision included in the Act as requested.

2) NZ DAIRY BOARD withdraws restructuring proposal as too risky with demands for exit provisions and attempts to hold together under present Act.

3) The Government responds to the call for an exit provision by introducing a sunset clause on all NZ DAIRY BOARD's statutory powers. This would effectively be an exit provision for all companies at a determined future date, giving time for alliances to form.

CONCLUSION

With a fair share of the NZ DAIRY BOARD's assets and fair access to quota markets, BMP was well positioned to compete with any combination of companies in the NZ context.

11.0 DEVELOPMENT OF THE THREE OPTIONS TO FIND THE BEST SOLUTION

As time progressed pros and cons for each of the options surfaced that would influence their overall acceptance, these are summarised as follows:

11.1 SUMMARY - OPTION ONE

The ***One Company*** scenario

In June 1995 BMP, along with Alpine Northland and Tui, presented the '*Four Company Proposal*' to the NZ DAIRY BOARD and the Dairy Companies. The proposal's foundation is the formation of a fully integrated export dairy industry with farmer shareholders and less, or minimal, company autonomy in favour of a unified structure with a common vision.

The two largest companies, KIWI and NZCDC reacted unfavourably to the proposal of *One Company*. This reaction made it clear that these two companies had long term strategic plans that did not involve an integrated *Single Company*. Without the support of these two large companies the *Single Company* option was doomed, but what was born from this was a desire from the total industry to identify areas of potential efficiency through improved alignment of manufacturing and marketing. This was to be know in the Industry as the *'Industry Efficiency Improvement Study'*.

The ***Industry Efficiency Improvement Study***

Terms of Reference:

i) To identify the potential operational efficiency improvements which may exist within the manufacturing/marketing interface area of the industry.

ii) To identify the magnitude of any identified potential efficiency improvements

iii) To identify what component of any identified efficiency improvement could be accessed under existing Industry Operational Methods.

iv) To note that the scope of the study should not be constrained by existing operational structures and practises.

CONCLUSION OPTION ONE

The *Single Company* scenario caused a major upheaval in the Dairy Industry and the *Industry Efficiency Study* was born. This *Study* brought the promise of major cost savings and increased shareholder wealth, through greater integration and efficiencies. However, the *One Company Scenario* did not find favour with the total Industry and BMP withdrew this as a viable and achievable option in the short term.

11.2 SUMMARY - OPTION TWO

A merger with NZCDC.

BMP soon realised that it had failed to convince the wider Industry of its concerns on *the Structural Package*. To continue to 'fight' against the proposal that the wider Industry accepted was only going to alienate the company and ultimately affect the company's revenue stream.

The BMP Board decided not to actively oppose *the Structural Package*, but rather lobby the select committee to include a protection for a minority Company clause.

This was now the opportune time to approach NZCDC about the merits of a merger of the two companies, the BMP Board instructed the chairman to start negotiations immediately while the company had bargaining power and a sound financial position.

CONCLUSION OPTION TWO

Although *the four company option* had been lost the *Industry Efficiency Improvement Study* had arisen from the ashes with the promise of increased shareholder wealth through better integration and cost efficiencies.

BMP reached the conclusion that the long term best interests for their shareholders was to align the company with a larger and dominant influence within the Industry. The reality was we could not beat them so the next best option was to join them , if a favourable deal could be achieved.

11.3 SUMMARY - OPTION THREE

BMP *'go it alone'* option.

Considerable work was put into this option with two different scenarios.

1) BMP could take its share of the NZ DAIRY BOARD and 'go it alone' to market its own products. Firstly, BMP would have to exit the Industry, this would seriously affect the single seller legislation of the Industry and the consequent responsibility for industry decline would be attributed to BMP.

Exiting the Industry would expose our shareholders to a high degree of risk in relation to:

- Poor market returns
- Product failure and or damages
- Non-payment for customer product
- Total research and development costs to develop new products
- Marketing expense.

The question, would we gain shareholder support for such an option?

2) BMP could operate a joint venture with a large overseas company that would open a whole new area of opportunity for product development and marketing.

Again, this would also bring the demise of the Single Seller Legislation as the NZ DAIRY BOARD would be forced to treat an overseas competitor as a shareholder.

A suitable partner was identified overseas and negotiations implemented to a point where the proposal was a viable option. Now it was decision time. This option would be a quantum leap in the Industry. Many people believed this type of joint venture may occur in the future, but would our shareholders support it now?

CONCLUSION - OPTION THREE

After careful consideration, the BMP Board's decision was that many BMP shareholders would want a merger with the NZCDC investigated as a first and logical step before a joint venture or *'go it alone' option.* It was established that a favourable merger would gain a wider acceptance than any other option and should be pursued vigorously. The joint venture proposal was placed on hold and the *'go it alone'* option filed as a last resort alternative.

PART II

C.C.HAMMOND
JULY 1997

12.0 BMP AND NZCDC MERGER NEGOTIATIONS

12.1 BACKGROUND

- In mid-August 1996, representatives of the BMP Board approached representatives of the NZCDC Board requesting a joint study be undertaken regarding the feasibility and economic benefits which would result from a merger of the manufacturing operations with the New Zealand Dairy Group of Companies (NZDG) and BMP and its subsidiaries (The BAY MILK Group).
- Following the *Industry Efficiency Study,* recently undertaken by co-operative dairy company members of the NZ Dairy Industry, each Board recognised the potential for manufacturing efficiencies and significant economic benefits to dairy farmers by merging the operations of the co-operative diary companies. They also recognised that the competitive advantage of the NZ Dairy Industry in international markets would be promoted by mergers which deliver further manufacturing efficiencies.

12.2 SCOPE OF MERGER STUDY

Both companies agreed to participate in the study on the following terms.

1) The study would proceed immediately, with a foreseen completion date prior to Christmas.
2) Both parties would co-operate and allocate the required personnel, as well as make available all resource information required to undertake a joint study.
3) There would be no preconceived ideas between the two companies regarding a possible merger other than it would developed from the respective financial positions for the 95/96 seasons and be based on financial forecasts for each company over the next five years.

12.3 MERGER STUDY OBJECTIVE

a) Identify financial benefits to be gained from combining the operations of the two entities.

b) Identify strategic benefits that would only be available if the companies merged.

c)The project teams endeavoured to reach a joint recommendation in regards to form and timing of any merger.

13.0 MID-SEPTEMBER 1996

By Mid-September excellent progress was made on the issues. Negotiations were proceeding in a favourable manner and a high degree of good will existed on both sides.

The decision, made by both companies to lodge an application with the Commerce Commission would establish whether the merger would receive the Commission's approval and what conditions might be imposed.

14.0 COMMERCE COMMISSION CLEARS NZCDC AQUISITION OF BMP

The Commerce Commission's approval was received before the end of September with no restrictions or provision on either party.

Commission Chairman, Dr. Alan Bollard stated, "*that if the proposal went ahead the group would not aquire or strengthen a dominant position in any market*". The merger would give the combined company 48.1% of the shares in the NZ DAIRY BOARD and 57% of the fresh milk sales in the Northern Island.

15.0 COMPANY REACTIONS

Both Companies were more than satisfied with the Commerce Commission's ruling. However, they strongly emphasised that the decision would not prejudge the ongoing discussions between the two companies to establish the benefits of a merger.

16.0 THE MERGER STUDY

The study involved three months work by senior directorate and executives of both companies. The assumptions on the study basics had been agreed.

17.0 PAST PERFORMANCES (refer to graph on page 4)

The cash generating performance of BMP and NZCDC have been comparable over the last five years.

BMP's position deteriorated in 1994 due to an unanticipated high milk flow and consequent processing and quality problems. On the other hand in the last fiscal year BMP performed significantly better than NZCDC.

17.1

NZCDC & BMP
PREVIOUS FIVE YEAR PERFORMANCE

	91/92	92/93	93/94	94/95	95/96
NZCDC					
PAYOUTS	343.3	372.5	339.0	350.0	410.0
RESERVES	5.8	10.2	11.0	1.8	0.1
DEPRECIATION	22.6	22.5	20.9	25.1	26.5
INTEREST (P&L)	8.4	5.9	4.1	5.3	7.5
EXTRAORDINARY	1.1	-1.0	-1.4	0.0	-2.0
TAX	0.0	0.0	1.2	0.0	-0.6
REAL SURPLUS EARNED	381.2	410.1	374.8	382.2	441.5
BMP					
PAYOUTS	335.0	355.0	328.0	339.0	408.0
RESERVES	2.1	12.7	0.7	5.5	-6.5
DEPRECIATION	31.8	37.2	33.9	33.6	30.7
INTEREST (P&L)	12.7	10.5	9.1	9.0	9.1
EXTRAORDINARY	2.0	0.0	0.0	-5.6	6.6
TAX	0.0	0.0	0.0	0.0	0.0
REAL SUPLUS EARNED	383.6	415.4	371.7	381.5	447.9
CENTS PER KG MS	2.4	5.3	-3.1	-0.7	6.4

BMP's balance sheet was impaired by higher retentions, an aggressive depreciation policy and constrained capital expenditure since 1991.

17.2 CURRENT PERFORMANCE

The BMP balance sheet now has a lower debt and a high equity ration than NZCDC.

Both companies were considered to be in a sound financial position.

17.3 COMPARISON WITH OTHER NEW ZEALAND COMPANIES

The comparison with other New Zealand companies, BMP and NZDG are performing approximately 40c/kg milk solids behind Tatua and 20c/kg milk solids ahead of the next group (Kiwi, Tui, Northland, Tasman). The remaining companies were performing at lower levels.

17.4 FUTURE PERFORMANCES

A comprehensive study was undertaken to forecast the performance of BMP and NZCDC through until Fiscal Year 2001. Representatives of both companies had exhaustively tested the assumptions and underlaying calculations of the forecasts.

An agreed financial position was reached. The relevant table has not been included because of its sensitive commercial nature.

The forecasts showed that there will remain little between the companies in the foreseeable future. The forecasts specifically excluded the possibility that either company would attack the others NZ DAIRY BOARD derived revenue by changes to cost models, incentives or other payments.

17.5 PERFORMANCE SUMMARY

NZ Diary Group

- higher milk growth with a higher investment requirement
- strong consumer growth strategy
- high through put cost efficiency through rationalisation to 'mega' sites

BMP

- lower milk growth and lower production capacity investment required
- strong consumer growth strategy
- strong on food ingredients and innovative product technology

Bottom line - very similar performance over next five years.

Both companies are a sound financial position.

18.0 MERGER BENEFITS QUANTIFIED

A merger between BMP and NZCDC would create a manufacturing entity which is more efficient, more cost effective, and capable of Industry leading performance in both the domestic and international markets. Ultimately it would be able to deliver improved shareholder returns. The new company will cover all major product lines with greater flexibility and productivity through consolidation and economics of scale.

18.1 TANGIBLE BENEFITS

The study showed a NET benefit in year one (ie inclusive of the costs incurred to merge the operations) of six million dollars which equates to just under 2c/kg milk solids. This should increase quickly over the first five years to over 20 million dollars per annum, which is in excess of 5c/kg milk solids to all suppliers.

18.2 NON-QUANTIFIED BENEFITS - OTHER FACTORS

The tax losses within BMP, the surplus head room shares, the higher equity and higher shareholder funding in BMP are recognised as valuable assets for a merging company. However, no attempt has been made to ascribe a value to these for the purposes of quantifying these advantages.

As a guide, BMP would have had approximately 8-10 million NZ DAIRY BOARD shares surplus to requirements at the completion of the five year interim period, at current milk growth rates. These surplus shares would be cancelled and have no value in five years time if not utilised in the required manner.

18.3 NON QUANTIFIED - INDUSTRY BENEFITS

The *Industry Efficiency Study,* identified 2-300 million worth of net benefits per annum available from an integrated structure versus the current two tier arrangement. A small proposition of these benefits would be achieved within the qualified benefits of the proposed merger:

- reduction in insurance costs
- better product mix planning
- maximising asset utilisation
- reduced overhead structure.

The majority of the *Industry Efficiency Improvement Study (IEIS)* benefits were in the area of establishing improved commercial drivers between marketing and manufacturing. The timing and ultimate probability of achieving these gains could be improved if there was a smaller number of large multi-products companies. This merger is a key step in achieving that end and therefore can be considered to be important in delivering a proportion of the identified 2-300 million to suppliers.

18.4 RISKS IN ACHIEVING BENEFITS

The major risks in achieving these benefits are:

a) loss of key NZ market customers due to dissatisfaction with either of the merging companies or a deterioration in customer service.

b) loss of the 'innovative culture' within BMP due to imposition of a new set of cooperate rules.

Both risks are fully recognised by both companies:

1) major NZ customers were kept informed and there was no evidence to date indicating dissatisfaction.

2) structures for the new company would assist in retention of the innovation culture within the various BMP operations and the spread of this approach through the appropriate subsidiaries of NZDG are already in the early stages of development.

Both risks were considered manageable.

19.0 DUE DILIGENCE

Due diligence from each company was fundamental to ensure there were no undisclosed legal or financial obligations detrimental to either group of shareholders. BMP used the services of lawyers Phillips Fox, and accountants Ernst & Young. NZDG contracted lawyers, Buddle Findlay, and accountants Coopers & Lybrand.

Areas covered:

1. Financial
2. Legal
3. Environmental
4. Markets, customers and products.

No significant obstacles were identified by either party.

The use of outside independent professional consultants gave independent credibility to the outcome of the merger study and clearly established and identified the merger proposals as 'fair' to both parties.

DUE DILIGENCE - CONCLUSION

Whilst a considerable number of issues were identified in the due diligence process nothing had been discovered which would materially alter the merger proposal on the basis recommended.

20.0 THE MERGER PROPOSAL

The key recommendation were:

1) The merger would be effective 1 June 1997

2) Following the merger all shareholders, of the merged company, would be subject to the same terms and conditions of supply, in particular those terms and conditions relating to payment for milk supplied.

3) That the merger take place on an equal term basis including the condition that no collection cost or other differential be levied on any of the dairy farms within the area currently supplying to BMP.

4) As part of the merger, supplying shareholders of BMP be allocated sufficient shares to ensure they have their full entitlement of shares in accordance with the NZDG share standards.

5) That BMP nominate two directors to sit on the NZDG Board for an interim period of 15 months, reducing to pro-ratio representations as applies to NZDG.

6) That a representation structure of committee men be set up in the BMP Supply area prior to 1 June 1997.

7) Compensation due to NZDG, from the NZ DAIRY BOARD, for sale of rights to the ANCHOR Brand, will be held for the benefit of NZDG suppliers who are shareholders as at 31 May 1997.

8) Shareholders meetings, for each company, would be held to seek support from 75% of those voting on the issue required. Shareholder meetings were held in late February, early March.

20.1 CONDITIONS OF SUPPLY

The conditions of supply for both companies are similar, the intention was to take the best from both companies.

CHANGES

1) Grading penalties, adopted by the new company, impact on BMP suppliers. Less for occasional grades and higher for persistent grades.

2) New company to adopt BMP comparative data milk dockets.

3) BMP current leptospirosis programme would not continue.

4) BMP current seasonal pricing programme would be phased out.

20.2 REACTION - FROM BOTH BOARD OF DIRECTORS

Both the Board of Directors, for BMP and NZCDC, unanimously supported the merger proposal and recommended the proposal be put forward to the shareholders for their consideration.

20.3 CONCLUSION:

i) The basis of the merger proposal was 'fair'.

ii) The merger benefits are substantial and quantifiable.

iii) Some benefits of the *Industry Efficiency Study* would be realised earlier.

iv) The merger creates a strong, innovative company covering all major product lines.

v) Both company Directors unanimously endorse this proposal as the best strategic option.

On Monday, 6 December 1996 both Boards finalised the proposal and accepted the proposed merger agreement.

21.0 MERGER - COMMUNICATION MEETINGS - DECEMBER 1996.

The BMP Board decided to hold a round of district shareholders meetings prior to Christmas to disseminate the information of the merger direct to the suppliers. The objective was to ensure suppliers understood the principals and that the information would be presented consistently . This would curtail any rumours and false policies that could threaten the proposal.

The second strategy, was to ensure that the Board knew and understood any supplier concerns on the proposal prior to the shareholders merger meeting. This would allow major areas of concern to be addressed and any changes made prior to final decision time.

21.1 SHAREHOLDER CONCERNS GRAPH

The following graph outlines the major topics of concern at the district supplier meetings. (p 11b)

21.2 MAJOR SHAREHOLDER CONCERNS RE: MERGER

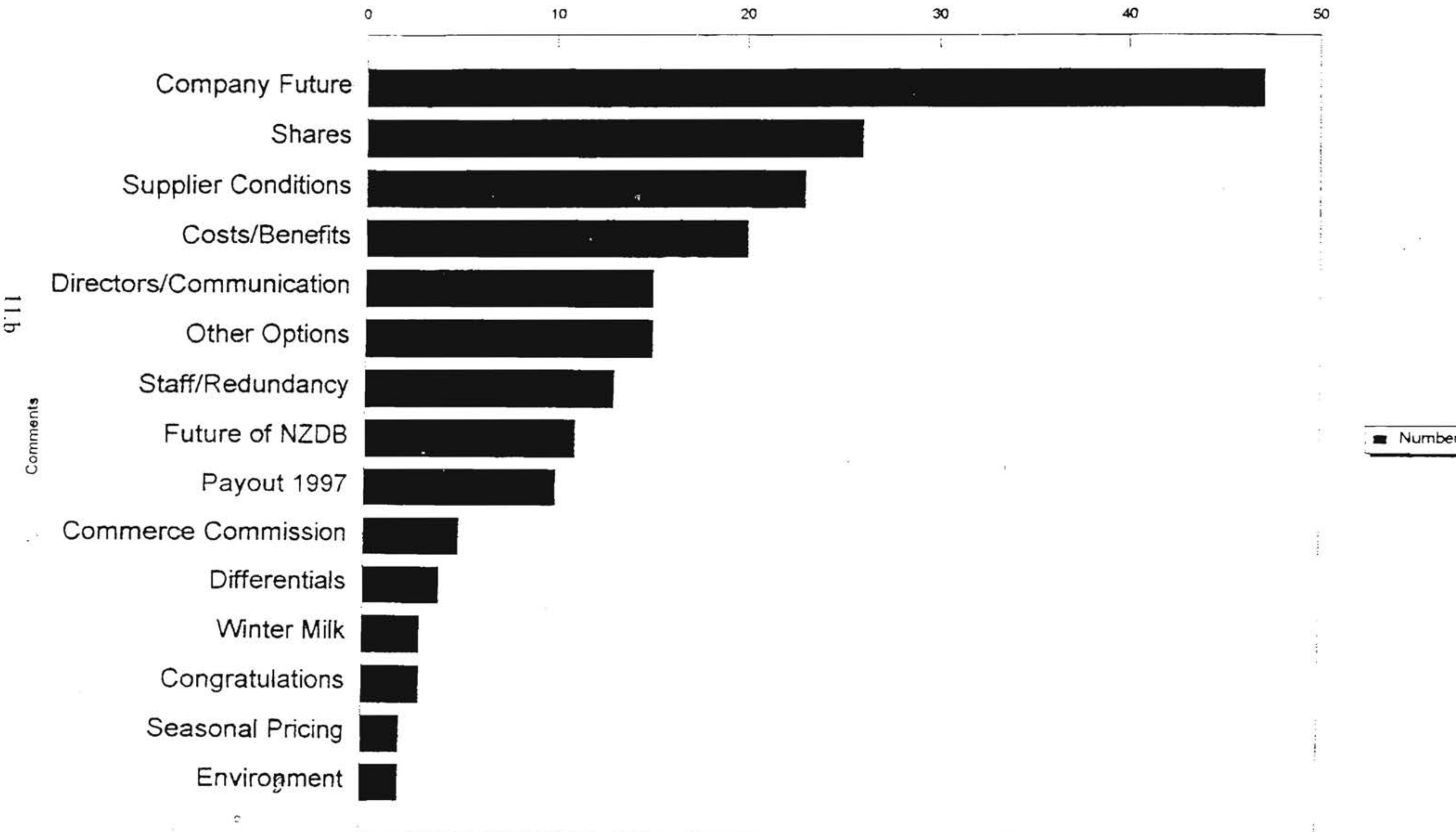
1) THE COMPANY'S FUTURE:

By far, the main area of concern was the future of the company. Many shareholders held the view that BMP had been rebuilt at great cost to themselves after the 1987 earthquake (ie: in the area of payout retentions). Shareholders believed the company was operating at the optimum level and it was now time to reap the rewards while the plant was relatively new.

Why should we merge?
This is our company why should we give it up?

21.1

COMMUNICATION MEETINGS RE MERGER
DECEMBER 1996



11.b

C.C.HAMMOND
JULY 1997

Also of concern was the social issue. The shareholders 'owned' this company and it was the hub of the community working like a 'family operation' because of its manageable size (845 suppliers).

What would happen to BMP?
Would NZCDC close it down in the near future to become derelict like so many other companies scattered around NZ, creating a ghost town in Edgecumbe?
What about the innovative culture developed at BMP?

2) **SHARES**:

Shares also caused concern amongst the shareholders, due to their complex nature, general lack of understanding and some suspicious attitudes towards the concept.

What was the NZDG share standard?
How much will we have to pay to gain shares in NZCDC?
How will our current share standard of 57c/kg milk solids be made to match NZCDC standard of 1-60/kg milk solids?
How does 'share bonus issues' work?

These are a few of the questions asked by shareholders.

3) **SUPPLIER ISSUES**

Many Shareholders were suspicious about the terms and conditions of the merger.

How much differential do we have to pay?
What about tanker track standards?
Will outside vats be allowed in the new company?
Milk Quality Standards - what's the difference?
What about our Quality Assurance Programmes?

4) **COSTS/BENEFITS**

Shareholders were keen to establish the costs/benefits to make sure neither company was substantially benefiting from merging with the other.

What will the cost of rationalisation be?
What is the cost of redundancies?
Is there really a 5c/kg milk solids benefit in the merger?
Why are we looking at a merger for 5c/kg milk solids when the single company concept can deliver 2-300 million. That must surely be the big prize!
Other NZCDC mergers don't seem to have delivered the perceived benefits, why should this one?

5) **DIRECTORS/COMMUNICATION**

Representation and communication was a hot topic for discussion, not only at the suppliers meetings but also in general conversation.

Representation:

Nine Directors for the BMP would be reduced to two. These two would be on the NZDG Board for 15 months, reducing to one Director thereafter.

Communication:

How will one Director communicate with 850 suppliers successfully?
How will the two Directors be decided?
How does the committee's man structure operate?
What power do committee men have? Aren't they just re-election committees?
The new company is so big won't we be just another number and our concerns never heard.

Many shareholders had friends and/or relations supplying NZDG and preconceived options entered the debate, which at times were not helpful because of inaccuracies.

ie: *"My brother-in-law told me that hundreds of people at BMP will be made redundant and the company would close in five years." "The committee man system doesn't work, it's a waste of time and energy."*

6) OTHER OPTIONS INVESTIGATED

This was an interesting area, as shareholders wanted to be reassured that all other available options had been considered and evaluated fully.

What about the single company study?
What about a joint venture with an overseas company?
Why can't we go one alone, if we were doing so well?

7) STAFF REDUNDANCIES

Shareholders held a genuine concern for staff at BMP and the potential redundancies. They saw BMP staff ,and the strong feeling of a 'family operation', as the success story of the company. The future of the 'innovative culture' developed at BMP, was a concern. This 'culture' was mainly accredited to staff and key staff were vital to its continuance.

8) OTHER ISSUES

All the other issues ranked accordingly in importance to shareholders but were not critical in the merger decision.

21.3 SUMMARY OF DISTRICT SUPPLIER COMMUNICATION MERGER MEETINGS

The most important issue in suppliers minds, regarding the merger, was the company's future. Suppliers had rebuilt this company at great cost from the 1987 earthquake and now it was performing with the industries best. To pass 'ownership' of BMP on to a large impersonal giant with long term uncertainly was a major social issue not to be taken lightly.

22.0 EXTRAORDINARY GENERAL MEETING

BMP - 26 March 1997
NZDG - 27 March 1997

All shareholders were mailed merger 'packages' prior to the Extraordinary General Meetings, to fully inform them of the issues and to cover the statutory obligations of the merger process.

The meeting at BMP was described as a 'sombre' occasion with wide spread feelings of sadness about the need for change. But these feelings aside, the shareholders understood the Industries issues and recognised the need for change, to secure their long term best interest.

'The decision rests with you the shareholders."

22.1 SPECIAL RESOLUTION

Accordingly, the shareholders accepted and endorsed the merger proposal.

"That in order to effect a merger between BMP Ltd and NZDG Ltd. that the proposed amalgamation between BMP Ltd and ANCHOR Farmers Ltd. be approved and proceed on the terms and conditions as outlined in the merger proposal dated 24 February 1997 circulated to shareholders."

A meeting with 75% approval was required. BMP Shareholders passed the resolution with 93% in favour and NZCDC suppliers with 87%. The merger had major shareholder approval.

22.2 EXTRAORDINARY GENERAL MEETING ISSUES

1) Of greatest concern was the complex legal process used to merge the two companies, BMP to a subsidiary of NZCDC

The reason for this was the requirement for:

a) An approved structure to allow the NZ DAIRY BOARD to transfer BMP shares to NZCDC as well as BMP's entitlement to Headroom Shares.

b) To prevent substantial tax losses of millions of dollars being forfeited and secure those losses for future tax write offs.

2) At the Extraordinary General Meeting, BMP Shareholders also approved a new constitution for the Company, in case the merger did not proceed. A Constitution was important to re-register the company under the new company act and allow BMP to carry on with business as usual. Time would be insufficient for this to happen should the merger process be delayed or not approved.

22.3 SUMMARY - EXTRAORDINARY GENERAL MEETING

BMP Shareholders viewed the Extraordinary General Meeting as a sombre and emotional event, but overwhelmingly endorsed the merger as securing their long term future. NZDG Shareholders also supported the merger by a high majority.

From June 1, 1997, BMP would exist only as a memory and the end of an era. Of note was a comment made at the meeting by a BMP shareholder who said, *"What sort of an Industry are we in where an innovative company like BMP, who was seen to do everything right, has to merge with a larger company to survive? There is something fundamentally wrong."*

23.0 MERGER IMPACT ON CURRENT BMP OPERATIONS:

Changes to BMP Operation as of the First of June:

i) The Edgecumbe site is to be expanded to become the new company's fifth mega-site.

ii) The site is likely to process five million litres peak capacity per day from the present 3.3 million.

iii) Milk collection area expanded to include the REPOROA area.

iv) Current Technical/Research and Development Resources are to be retained and rolled out into other 'mega sites'.

v) Retail - RIVERSLEA Farm Services will merge with ANCHOR MART (NZDG). The remaining non-core retail activities will be divested as per the current BMP plan.

vi) Food ingredients will be merged with RIVERLEA DAIRIES (NZDG). The BMP TePuke site will be maintained in medium term with one Auckland Head Office.

vii) Consumer products, Intermilk and NZ Dairy Foods (NZDG) will be merged. The two sites maintained in the medium term, with a possible future 'green fields' single site planned.

viii) BMP Head Office will be mostly redundant, some staff will be relocated to other new company operations.

ix) Total redundancies in BMP operations will be approximately 50 at merger.

23.1 MERGER IMPACT NZDG

Many of the BMP issues also impact on NZCDC:

- Earlier closure of Reporoa and milk transferred to other sites.
- Redundancies at Reporoa brought forward plus other operational redundancies.

23.2 COMPANY MERGER IMPACTS SUMMARY

The BMP site will expand at an accelerated rate to process the milk from Reporoa Region, which faces earlier closure.

Both Companies' operations will be rationalised with minimal staff redundancies and some relocations.

24.0 NEW COMPANY PROFILE

7,000 Shareholders representing 48 % of the Dairy Industry. The combined turnover on 1995/96 figures being 2.7 million. One of the 10 largest companies in NZ.

25.0 THE FUTURE

What is in the future?
Who knows, but what is definite is there will be change!

Sir Dryden Spring spoke of 'Rapid and Exciting" change in the NZ Dairy Industry at a recent Dairy Conference in Whakatane. Sir Dryden's key point *was "Those who lead the changes do much better economically than those who resist them."* There is no doubt the new company will be the industry's leader.

The strategic intent of the new company is to continue to out perform current or future companies in NZ.

But for the residents of Edgecumbe and the BMP suppliers, one paramount question still remains tucked away in the back of their minds, *Will the Edgecumbe factory succumb to progress and die a quick death like those who have gone before, or will it prosper under the umbrella of New Zealand's largest dairy co-operative?* Only time will tell.

26.0 ACKNOWLEDGEMENTS

The merger ended my term as a Dairy Company Director. I thoroughly enjoyed my time on the Board and I have gained a considerable amount of knowledge and experience from working with the Directors, Executives and staff at BMP. In my opinion, BMP had governance and management second to none in the NZ Dairy Industry.

It has been a privilege to represent the BMP suppliers on the Board and I thank them for their support and encouragement.

This reports was written with material and press clippings distributed to me in my capacity as a BMP Director and Shareholder.

C.C. Hammond