

Asset Beta for Fonterra's Notional Business: Further Comments



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Introduction

- Interpretation of “*practically feasible*” - does the asset beta for Fonterra’s Notional Business reflect the allocation of systematic risks borne by the processor and suppliers (farmers) in accordance with the “rules” to set the milk price under the Milk Price Manual.

Fonterra’s Notional Business is exposed to risks of:

- Under-recovery or over-recovery of actual costs relative to “efficient costs”;
- The consequences of any differences between Fonterra’s actual RCP asset base and the asset base prescribed in the Milk Price Manual; and
- The consequence of differences between Fonterra’s Notional Business’ funding decisions and those of the assumed Milk Price Notional Processor.

A Key Risk facing Fonterra's Notional Business is the cash flow risk.

The "net cash flow" risk is now [see UniServices Report No 2 (2016) and Lally 2016 (a)]:

$$\text{NCF} = \text{EOTH} - \text{AOTH}$$

Where:

NCF = net cash flow.

EOTH = ex-ante efficient costs other than the purchase of milk for a business that sells RCPs with sales on and off GDT.

AOTH = actual costs other than the purchase of milk.

Are betas for Electricity Lines Businesses valid comparators?

- Auckland UniServices has used asset betas for ELBs as the “reference point” for the asset beta of Fonterra’s Actual and Notional Businesses.
- Why? We conclude that the “risk” allocation between Fonterra’s Notional Business and farmer, where the milk price is set under the Manual, means the business has systematic risk that is low (but not riskless).
- Advice to the Commission by Lally (2016b, page 8) also states:
“So, suitable comparators must have similar systematic risk but this does not require similarity on all (or even any of the) dimensions that underlie systematic risk. The ELBs are of this type in relation to the Notional Business.”

Updated beta estimates for Global Dairy Businesses

- See Table 2 – Auckland UniServices (2017)

Table 2: Summary of asset beta estimates						
Combined Two and Four-weekly beta	All periods	31/03/2017	6/01/2017	14/10/2016	22/07/2016	29/04/2016
Material Commodity Exposure						
Average	0.50	0.47	0.46	0.51	0.53	0.53
Median	0.52	0.51	0.52	0.52	0.53	0.53
Both Commodity & Brand Exposure						
Average	0.49	0.47	0.47	0.49	0.51	0.52
Median	0.47	0.47	0.47	0.47	0.47	0.47
Brand Exposure						
Average	0.52	0.52	0.52	0.51	0.52	0.52
Median	0.52	0.50	0.51	0.52	0.54	0.55
<i>Source: EY New Zealand analysis of betas and UniServices analysis</i>						

Which processors in other markets can adjust their prices for farmers' milk both during and at the end of the season, and hence transfer risk, including commodity price risk, to their suppliers?

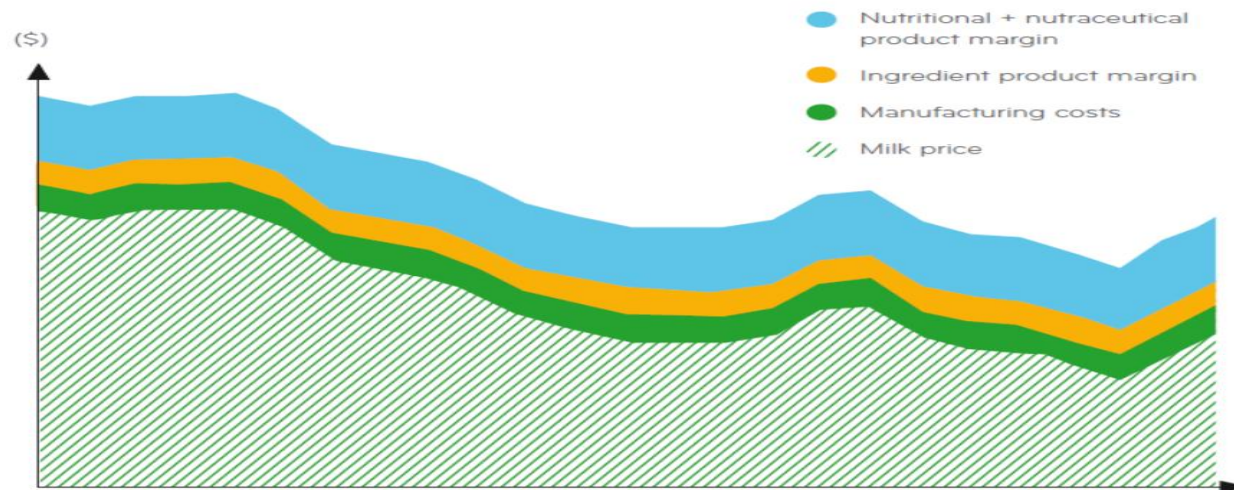
Based on discussions with Fonterra

- Murray Goulburn is committed to a mechanistic formula under which in the normal course, between 92.5 – 96.5 percent of actual net earnings prior to paying for milk (but after all other costs, including interest and tax) would be allocated to the milk price.
- Bega does not appear to have the direct ability to transfer reductions in Bega-specific revenue through into its milk price.
- Warrnambool Cheese and Butter Factory Company no longer listed on the ASX.

The Synlait “Investor update” of December 2015

Provides a graph for illustrative purposes that shows that:

“When the milk prices are high, our revenue is higher however our gross margin is unaffected. When the milk price is low, revenue is also lower however our gross margin is still unaffected”.

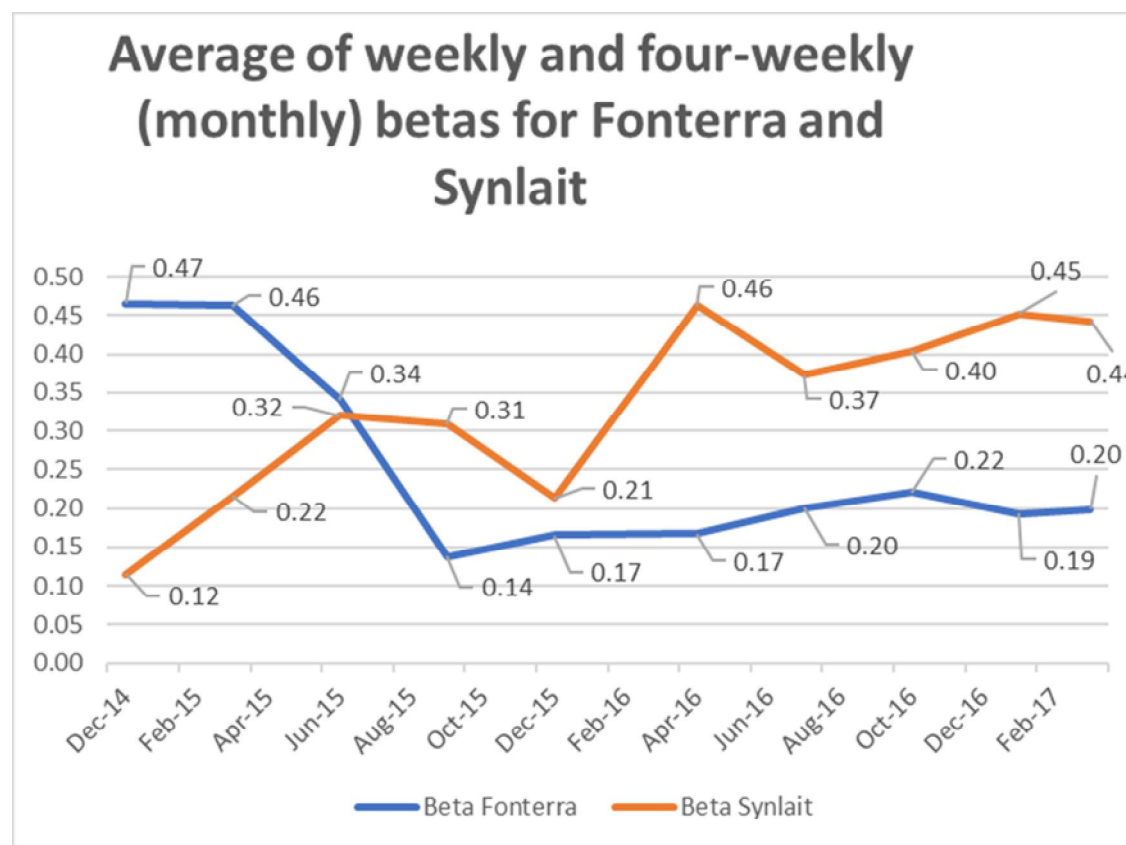


NOTE: This graph is intended as an illustration only and does not reflect any actual sales or forecast figures.

Source: Website of Synlait Milk Ltd

Empirical evidence on Fonterra and Synlait's asset beta

- Figure 1 (Auckland UniServices, 2017)



Is size of downward adjustment from 0.51 – 0.52 to 0.38 reasonable?

Components of beta

$$\beta_{Fonterra} = \frac{\beta_{NB} \times V_{NB}}{V_F} + \frac{\beta_{VA} \times V_{VA}}{V_F}$$

$$\mathbf{0.44 \text{ to } 0.45} = \frac{0.38 \times 0.52}{1} + \frac{(0.51 \text{ to } 0.52) \times 0.48}{1}$$

The implied asset beta for Fonterra's total business of 0.44 – 0.45 is:

- Towards the upper bound of the average of the empirical estimates of asset beta for Fonterra of 0.14 to 0.47 (see Auckland UniServices, 2017, Figure 1).
- Above the 25th percentile estimate (0.37) and just below (or at) the 40th percentile estimate (0.45) for all the comparator sample of companies in Table 1, Auckland UniServices, 2017.

Is size of downward adjustment from 0.51 – 0.52 to 0.38 reasonable? Cont.

Asset beta		
0.38	0.44 - 0.45	0.51 - 0.52
100% Notional Processor	Fonterra - circa 52% "Processor" and 48% "Value-add business"	Significant (100%) "Commodity & Brand" / "Brand" exposure
Asset beta		
0.60	0.65	
Airports - aeronautical activities	Airports - aeronautical and non-aeronautical activities	
See Commerce Commission IM Review Decisions (Dec 2016)		

- Downwards adjustment is 0.06 – 0.07 relative to Fonterra’s asset beta as a whole.
- Note: In the case of Airports in the Commission’s Input Methodologies review decisions (2016), the Commission made a downward adjustment of 0.05 for Airports from 0.65 to 0.60 (where the empirical estimate of 0.65 reflects a value weight, where there is considered to be a significant allocation to airports’ aeronautical activities in this empirical estimate). See Lally, M, 2016, Review of Further WACC Submissions, 23 Nov 2016, Website Commerce Commission and Commerce Commission Input Methodologies Review Draft Decisions (2016), Table 8, Page 475 of 790.

Conclusion

- Auckland UniServices' reports seek to conclude on an asset beta for Fonterra's Notional Business which reflects the allocation of systematic risks borne by the processor in accordance with the "rules" to set the milk price under the Milk Price Manual.
- Except for potentially Synlait (and Murray Goulburn ?), no comparative listed companies have the ability to make ex-post adjustments to pass through all material revenue variances between forecast and actual performance to the milk price (this point should "replace" para. 9.2b of Auckland UniServices, 2017).
- ELBs are a valid comparator to estimate the asset beta for Fonterra's Notional Business.
- De-composition of the asset beta for Fonterra's combined business, comprising both "Processing Operations" and "Value-Add Components" is consistent with an asset beta of 0.38 for Fonterra's Notional Business.
- In Auckland UniServices' view, no change in our point estimate asset beta for Fonterra's Notional Business is 0.38