Supplier Information Sessions

Post-session Q&A summary
3rd edition

The following is a summary of key questions asked by MG's suppliers at recent Supplier Information Sessions or received in advance by email. Summaries of questions from previous meetings were published on the MG website on 17 July and 15 August 2016.

1. Market conditions seem to be improving - when will there be a step-up?
Following last week's supplier meetings across our Southern Region, we are pleased to have announced a step-up in our FY17 farmgate milk price of $0.11 per kilogram butterfat and $0.22 per kilogram of protein. This is equivalent to $0.15 per kgms. This takes MG's weighted average available FY17 farmgate milk price to $4.46 per kgms after the Milk Supply Support Package (MSSP) repayment amount of $0.14 per kgms, which remains unchanged pending the review of the MSSP. For suppliers who elected to pre-pay their MSSP amount, the average available farmgate milk price is $4.60 per kgms. We have also announced an increase in our FY17 full year weighted average available forecast from $4.80 per kgms to $4.88 per kgms. These outcomes reflect an improvement in the global dairy commodity market after a particularly challenging period for processors and dairy farmers around the world. It also reflects rigorous control and discipline we have sought to embed concerning farmgate milk pricing to offer suppliers more confidence in the decision-making process.

2. What options are being considered in the MSSP review that's been announced?
All options are on the table and the objective is to reduce the burden of the MSSP on our suppliers – particularly in this low farmgate milk price environment.

3. Why can't the MSSP be reviewed more quickly, given it was developed over the course of the ANZAC long weekend?
The MSSP was selected from a range of options in a short space of time by necessity, due to the scale of the missed forecast and the Board's recognition of the financial pressures already being faced by suppliers due to the exceptionally dry conditions at the end of last season. The review of the MSSP is complex and we need to undertake thorough due diligence on the alternative options, in order to provide a better solution to support suppliers in the long term interests of suppliers and MG. We've committed to providing an update on this issue before the AGM on 28 October 2016.

4. How will this review impact suppliers who made an early repayment of the MSSP?
Suppliers who participated in the option to make an early repayment of the MSSP in June 2016 will of course be fully recognised in whichever alternative option is selected as part of the MSSP review. Early repayment of the MSSP by suppliers amounted to approximately $7 million.

5. Is the MSSP legal – is it legal that we need to payback more than we were paid?
The MSSP was introduced as the best option to support farmers at the time of the farmgate milk price reduction in April, with many already struggling with additional costs due to the exceptionally dry seasonal conditions. The MSSP was implemented via the rights MG has under its standard milk payment terms to set the opening price.

6. Should MG have levelled a debt against each farmer?
This question was answered in Q10 of the 'Post-session Q&A summary' published on 17 July 2016 available here.

7. Why is the MSSP regarded as an 'asset' in MG accounts?
The MSSP is treated as an asset on MG's balance sheet as an amount advanced to suppliers. To the extent that suppliers cease to supply MG by retiring or transferring to a competitor, the amount of the asset is required to be impaired. The advances are interest bearing over the life of the advance. The repayment of the MSSP advances occurs by MG withholding an amount of milk payments to suppliers and is expected to be recovered over the next three years.

8. Has the new capital structure caused this problem?
No, this is not the case. Dividend payments to supplier/shareholders and distributions to unitholders only accounted for 3.5% of the Distributable Milk Pool (DMP) in FY16. Unitholders received one third of these distributions or approximately $14 million. The external equity funding raised from unitholders during the IPO of the MG Unit Trust provided a number of benefits to the MG Group in the last 12 months. In particular it significantly reduced MG's gearing, which closed FY16 under 30% - despite an MSSP program of $183 million. This reduction in interest payments on MG's previous debt facilities has supported the DMP. This means MG's balance sheet is strong at a time of challenging market conditions and will mean MG can continue to make decisions, particularly around investment, that will be in its long term interests.

9. What has MG put in place to prevent the events of April occurring again?
MG has very strong procedures and processes in place to test the assumptions used in preparing forecasts. The missed forecast was caused by a sudden change in market conditions, which could not have been foreseen. However, there are lessons from those events and which we have already put in place. We are rebuilding trust in our pricing by being disciplined and prudent. We also recognise the need for greater focus to be placed on the execution of our strategy. This includes the cost reductions we recently announced as well as improved business performance.

10. Why did costs build up to such an extent in FY16?
Costs rose in FY16 for two main reasons. MG's distribution costs were higher due to increased inventory holdings compared to FY15 and the shift of our product mix into Dairy Foods. We also had increased marketing costs to support the product releases of Devondale Milkshakes and 8Bar iced coffees. However the general increase in costs across the business was not acceptable and we have conducted a review of overheads, which has identified annualised cost efficiencies of between $50 million and $60 million, primarily from reduced headcount (predominantly positions associated with head office), procurement benefits, and systems improvement. MG expects to deliver $10 million to $15 million of these savings in FY17.

11. How is MG able to cut 200 staff – what were all these people doing?
The headcount reductions we have announced with our FY16 Results relate to existing as well as budgeted roles, rather than only redundancies of current employees. The reductions will primarily impact positions associated with head office as well as MG Trading. This includes existing vacancies that won't be filled, resignations that won't be replaced, conclusion of contracts and also redundancies.

12. Why isn't there more advertising for Devondale?
MG is working on the development of a new advertising campaign which will have an emphasis on supporting Australia's 100% farmer controlled co-operative and how Australian dairy farmers are committed to making high quality dairy products. We have also sponsored the recent series of *MasterChef*.

13. How much milk have we lost? What is the split between seasonal and flat?
MG has experienced net losses of approximately 300 million litres during this season. This equates to approximately 8% of milk supply through suppliers moving to other processors or retirements from the industry (around 240 of MG's 2,400 suppliers). Losses have occurred across all regions. In addition, MG's overall milk supply is down year on year due to very wet climactic conditions during the start of the season. We have lost both FMI and non-FMI herds.

14. How will lost milk supply impact our factories?
MG has clear plans to reduce manufacturing costs in line with milk supply to insulate the farmgate milk price. We also have flexibility to move supply between plants to maximise efficiency.

15. At what point will milk losses become a significant issue for the Co-op?
MG understands the loss of confidence amongst suppliers and we are working hard to improve the farmgate milk price to start to rebuild this confidence and limit milk supply loss.

16. Do we need to return to a simpler farmgate milk price structure without incentives that is easier to understand?
We undertake periodic reviews of our farmgate milk pricing structure. This was last fully reviewed in 2013 and significant changes were made at that time including moving more payments into the peak base price and moving to a single base price. MG will continue to have dialogue with suppliers about how to best distribute the milk pool.

17. MG's FY16 Results show only a slight decrease in revenues - why was it necessary to cut the farmgate milk price by so much?
Lower revenues in Ingredients were driven by lower commodity prices which have reduced the DMP. This has not impacted the cost of Ingredients products and therefore this reduces margin to the extent of the commodity price reductions. In addition higher costs in distribution, sales and administration as well as higher volumes of inventory at June causing larger inventory revaluation than previous periods.

18. What is the latest on appointing a CEO?
The Board is well progressed in the global search for the appointment of the CEO. We have previously advised that this would take approximately six months. David Mallinson is working as interim CEO and has the full support of the Board. He will be considered in the candidate selection process.

19. What is the difference in the appointment of a CEO/MD - will we be appointing an MD?
The Constitution of the Co-operative provides that the Board can appoint a Managing Director. The difference between and CEO and MD is whether they are appointed as a Director of the Board.

20. What have Directors done to deserve a pay increase?
An independent benchmarking review conducted by Ernst & Young last year highlighted that MG Directors fees were well below the average for similar sized companies (ASX comparator group companies). As the setting of the Director pool is a shareholder matter, this increase was put to shareholders at the EGM in May 2015 to approve the capital structure. Suppliers agreed, with approximately 75% voting in favour of the fee increase at the EGM. The Board unanimously agreed to waive Directors fees for May and June in recognition of the challenges facing the co-operative.

21. What value do Special Directors add?
MG is a farmer co-operative and our Board structure reflects this fact. The Board is also supported by Special Directors, who bring additional outside and professional experience to its deliberations.

22. Should we have more Special Directors on our Board?
The Board is committed to securing a third Special Director and is in the process of doing so. A fuller answer to a previous question about the structure of the MG Board and the role of Special Directors can be found in Q10 of the 'Additional post-session Q&A summary' published on the MG website on 15 August available here.

23. Why doesn't the Board take a bolder view about cost savings e.g. selling MG Trading?
Every aspect of the Co-operative's strategy and operations is under review to reduce cost and improve efficiency.

24. Why did not all the MG Board attend the meeting with the Prime Minister and Deputy Prime Minister in Canberra?
MG was well represented by senior Board and executive members. However, the full Board did not attend due to the unavailability of some Directors and a desire to save costs as part of our efficiency measures.

25. MG's investment in the new SAP computer system is a big ticket item – what benefits will it bring?

Our implementation of SAP technology across MG is a business transformation project that has delivered an integrated, end to end solution changing more than 80% of processes and driving efficiency gains, improved data accuracy and reporting capabilities. Our total spend on this technology investment is $72 million. The project was a significant undertaking for MG across all of our operations and will be a key enabler not only of our growth strategy moving forward, but also the cost reduction program we announced at the time of our FY16 results. It will enable MG to reduce overhead costs throughout the business in the future, replace an aging and fragmented set of bespoke applications and support planned efficiencies. It will deliver significant benefits and capability including automated and real-time tracking of milk products to customers, improved real time end-to-end reporting, ability to generate accurate forecasts in significantly shorter time periods and automates many existing manual processes.

26. What is MG doing with the Leitchville site?

Leitchville is an important site for MG. Although it has been closed for some years, the physical plant and equipment is still in excellent order. This includes a high quality cheese production line which has the potential to be reused in the future if required. We continue to keep all options open for the site and there is currently no plan to vacate the site.

27. How will our debt position look after the nutritionals investment?

Our balance sheet and gearing position is currently strong, which gives MG the ability to fund our intended major capital projects. This funding ability is expected to be further enhanced by MG's announced focus on cash generation from working capital. Over time, MG would expect debt to increase as major projects are completed, with gearing to remain within management's targeted range. MG's planned nutritionals investment is an important strategic pillar, which will enable greater value to be created from Skim Milk Powder.

28. What is the latest with MG's inventory reduction?

At year end, we had a higher inventory revaluation amount vs FY15 of $61 million. This will reverse once inventories are realised and assist in improving working capital. Management of inventory is a key performance indicator for FY17 with a $100 to $110 million sustainable inventory reduction targeted for FY17 through selling production more aligned to the milk production curve and working through the existing adult milk powder inventory.

29. How are sales of adult milk powder sachets in China progressing?

MG is making good progress with its offline distribution and seven distributors have been added to the network since April. In addition we have further developed our key account relationships with major retailers such as RT Mart and Carrefour. MG will be in a position to update the market on first quarter trading at the AGM on 28 October.