

9 November 2021

Synlait Milk Limited (SML)

The company will hold its Annual Shareholders Meeting at **1.00pm Wednesday 1 December 2021**.

It will be a virtual meeting. You can join the meeting at

<https://apps.computershare.com/MeetingsShareholderWeb/FindMeeting?Country=NZ>

Company Overview

Synlait was co-founded by Dr John Penno in 2000. By 2005 the company owned 8 farms and in 2007 constructed its first plant at Dunsandel Dairies, one of its larger farms. In 2010 Bright Dairy China took a major stake in the company and in 2013 SML listed on the NZX, going on to list on the ASX in 2016. Bright Dairy are the largest shareholder at 39% whilst a2 Milk hold 19.8%.

In 2017 the company acquired New Zealand Dairy Co. and in 2018 acquired land at Pokeno north Waikato for the construction of a nutritional powders plant. In April 2020 the company acquired Dairyworks Ltd and August 2020 acquired farmland adjacent to Dunsandel to allow for expansion.

We have previously commented that whilst Bright Dairy owns 39% of the shares it appoints 50% of the Board. Together with a Managing Director this results in the Board only have three Independent Director. Whilst NZX have granted a waiver in this respect we note the NZX Code of Corporate Governance states at 2.8 "A majority of the Board should be independent Directors". This is also NZSA policy. We further note that other NZX companies with up to 75% majority shareholders still have a majority of independent Directors in order to protect the interests of minority shareholders.

In April 2021 Leon Clement resigned as CEO. He had served since September 2018. This has triggered a series of governance actions to manage through the interim period prior to a new CEO starting.

- Dr John Penno was appointed Acting CEO following Leon Clement's resignation.
- Graeme Milne, who has served since 2006 and is the Chair, will retire in January 2022 and will be appointed a Board Advisor for one year to assist in the transition
- A new CEO Grant Watson also joining the company in January 2022.
- Dr John Penno will be appointed as a Non-Independent Chair - however this is intended to be a temporary situation with an Independent Chair being appointed in the near future.
- In January 2022 the Board will appoint Paul McGilvary as an Independent Director to replace Graeme Milne.

Current Strategy

The company's strap line is "doing milk differently for a healthier world". It is committed to sustainability across three pillars of activity, environment, people, and enterprise.

Key

The following sections calculate an objective rating against criteria contained within NZSA policies.

Colour	Meaning
G	Strong adherence to NZSA policies
A	Part adherence or a lack of disclosure as to adherence with NZSA policies
R	A clear gap in expectations compared with NZSA policies
n/a	Not applicable for the company

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Governance

NZSA assessment against its key policy criteria is summarised below:

Policy Theme	Assessment	Notes
Directors Fees	G	See comments below.
Director share ownership	G	Directors are not required to own shares.
Executive Remuneration	G	See comments below.
Golden parachutes/handshakes	A	No disclosure as to whether these have been paid.
Director Independence	R	See comments below.
Board Composition	A	See comments below.
Director Tenure	A	See comments below.
ASM Format	G	Virtual due to uncertainty around Covid restrictions.
Company Sec independence	G	Generally good disclosure although not disclosed if a profit-based incentive is paid.

Directors Fees: Synlait discloses the fee pool approved by shareholders for the Chair, Committee Chairs and non-executive directors as an alternative to disclosing the *total* fee pool available for directors. This alternative view is also supported by NZSA. The company does not disclose whether retirement benefits or share options are paid to Directors, a position generally not supported by NZSA. We have had a discussion with the company and are comfortable with their position on this matter.

Executive Remuneration: The CEO is paid a base salary and a long-term incentive (LTI). NZSA encourages fulsome disclosure in relation to any incentive payments made to the CEO, including disclosure of measures (or measure ‘groups’), weightings, targets and the level of achievement associated with any awards. For the total incentive opportunity, we also prefer a weighting to LTI opportunity – as Synlait does not operate a short-term incentive scheme, that is clearly the case.

The metrics and weightings associated with LTI (Earnings per share and Total Shareholder return) are well disclosed, together with their associated target. The maximum opportunity compared with base salary (25%) is also well-disclosed.

There is also no disclosure as to severance arrangements applicable to the CEO.

Director Independence: Synlait operates under a waiver from the NZX that allows major shareholder Bright Dairy (owning 39.119%) to appoint 4 directors to the Synlait Board (out of 8). In addition, the current Acting CEO is also a “Board-appointed Director”, allowing only 3 independent directors. NZSA believes that a Board should comprise of a majority of independent directors, for the benefit of all shareholders – regardless of ownership structure.

We do note that Synlait does not have a recent history of having its CEO on the Board; we recognise this may simply be a transitional arrangement. However, the role of a Board-appointed director is also not regarded as independent by the company.

We note that a change is being implemented at this ASM to allow either an independent director or the Board-appointed director (ie, Dr John Penno) to hold the role of Chair, until the next ASM in 2022.

NZSA considers that this offers scope to further reduce the independence of the Board, but does note the limited timeframe.

The company explains in its Notice of Meeting that the current constitution has the effect of only 2 people being eligible as Chair, with the potential that neither are available to take up the Chair role.

In discussions with NZSA, the company has noted that investors have invested in Synlait with the understanding of the constitutional arrangement to ensure Bright Dairy's board representation, and the non-standard governance is well signalled by the 'NS' designation against the SML ticker code on the NZX. The company also noted that the arrangement cannot be changed without the support of the existing Bright directors (who hold a majority on the Board).

Nonetheless, NZSA considers that the Board, particularly its independent directors, should at least discuss a change to see whether there is any pathway to a majority of independent directors.

In short, NZSA is concerned that the company appears to be moving to further towards reducing independence on its Board (albeit for a limited timeframe) as an alternative to planning for a longer-term, more fundamental review of its governance structure.

Board Composition: There is no skills matrix to demonstrate how the individual Directors skill sets contribute to the governance of the company.

It is disappointing that the company does not participate in the IoD's "Future Director Programme"; we feel that the company would be in a good position to offer an effective experience to emerging directors and contribute to the development of director capability in New Zealand.

Director Tenure: NZSA looks for evidence of ongoing succession or 'staggered' appointment dates that reduce the risks associated with effective knowledge transfer in the event of succession. We also prefer a term maximum of 9-12 years, unless there are exceptional circumstances that may apply.

We note that Synlait has a range of appointment dates between 2009-2020, indicating an ongoing focus on maintaining board renewal. This excludes the current Chair Graeme Milne (appointed to the Board in 2006) who is retiring shortly after this ASM.

However, we note the Hon Ruth Richardson has served on the Board of Synlait and its predecessors since 2004 and Sihang Yang since 2010 (11 years). Both are Bright Dairy appointees and not required to stand for re-election. Given their tenure, NZSA would prefer to see further evidence of succession management, to ensure ongoing governance sustainability.

ASM Format: The shareholder meeting has been planned as a virtual-only meeting, a decision supported by NZSA in this context. Normally, NZSA favours a hybrid meeting, to maximise shareholder attendance and engagement through both virtual and physical means.

Audit

NZSA assessment against its key policy criteria is summarised below:

Policy Theme	Assessment	Notes
Audit independence	G	Good disclosure
Audit rotation	A	See comments below.

Audit Rotation: Whilst the company ensures the Lead Audit Partner is rotated at 5 years it does not disclose whether the Audit Firm is rotated at 10 years. In common with many other NZX-listed companies, it also does not disclose the appointment date of the Audit Firm or the Lead Audit Partner. We note that a resolution at this ASM proposes to appoint PwC as auditor (currently: Deloitte).

Ethical and Social

NZSA assessment against its key policy criteria is summarised below:

Policy Theme	Assessment	Notes
Whistleblowing	G	Good disclosure
Political donations	G	No donations were made

Financial & Performance

Policy Theme	Assessment	Notes
Dividends and Imputation	n/a	There was no dividend paid.
Capital Raise process	G	See below

Capital Raise process: During the year the company raised capital by way of a Placement and a Share Purchase Plan. NZSA's preferred method is a renounceable rights issue to allow shareholders to maintain their proportionality or derive some benefit from the sale of rights.

We note in the Placement and Share Purchase Plan the company took steps to endeavour to ensure existing shareholders were able to maintain their proportionality.

Synlait's share price fell from \$5.93 to \$3.46 (as of November 9th) over the last 12 months – a 42% decline. This compares unfavourably with the NZX 50 which increased by 4% in the same period. The **Performance Factor** for SML is -10.92.

Metric	2021	2020	Change
Revenue	\$1,367m	\$1,302m	5%
Gross Profit	\$67m	\$204m	-67%
NPAT	-\$28.5m	\$74.3m	n/a
Gross Profit Margin	5%	16%	-69%
Inventory Turnover	4.81	5.06	-5%
EPS ¹	-\$0.13	\$0.414	n/a
PE Ratio	n/a	14	
Current Ratio	1.45	1.00	45%

Debt Equity	1.11	1.46	-24%
Operating CF	\$15.8m	\$103.8m	-85%
NTA Per Share ¹	\$2.94	\$2.78	6%
Dividend Per Share ¹	n/a	n/a	

¹ per share figures based off actual shares at balance date (not weighted average)

The opening paragraph of the [Chair Review](#) in the Annual Report sums up the difficult year SML had and outlines the challenges they face: “Our financial result for the 12 months to 31 July 2021 (FY21) unfortunately reaffirmed our over reliance on one product, one customer, and one market. While we have invested significantly in our diversification strategy, we did not anticipate the impact COVID-19 would have on The a2 Milk Company, our key customer, and consequently, our own financial performance”.

This over-reliance on one customer meant that while revenue was up by 5% to \$1,367m, cost of sales increased significantly to \$1,300m and the gross profit margin declined from 16% to 5%. This affected the bottom-line with a loss after tax of \$28.5m reported. For the 2021-year SML had negative EPS of \$0.13.

During November 2020, SML announced the need to bolster the balance sheet and a \$200m equity raising was completed. On 30th July 2021, SML [announced new funding arrangements](#) with their banking syndicates.

Following the capital raise, the company is in relatively sound financial position with a current ratio of 1.45 and a debt equity ratio of 1.11. The \$200m capital raise notwithstanding, non-current interest-bearing debt increased by 8% to \$460m.

SML has an NTA of \$2.94 and the shares trade at a modest 18% premium to NTA.

SML does not pay dividends.

In a forward-looking statement released on 27 September, SML provided guidance expecting its NPAT result to return to robust profitability in FY22 based on:

- a return to normal trading conditions and tighter management of its Ingredient business;
- improved infant base powder volumes;
- a growing contribution from its Liquids and Consumer Foods business units; and
- targeted and significant cost savings from Synlait, Dairyworks and Talbot Forest Cheese.

Resolutions

1. That PricewaterhouseCoopers be appointed as auditor of the Company and that the Board be authorised to determine the auditors’ fees and expenses for the 2022 financial year

NZSA appreciates that shareholders are being asked to vote on the appointment of the new auditor, as well as the authorising the Board to determine audit fees.

We will vote undirected proxies **IN FAVOUR** of this resolution.

2. To re-elect Graeme Milne as an Independent Director.

Graeme Milne was appointed to the Board in 2006 and is the Chair. He is the Chair of Terracare Fertilisers Ltd, PF Olsen Limited, Braemar Hospital Limited and of the Advisory Board for Rimaniui Farms Ltd. He is also a Director of Alliance Group. Ltd.

As reported above he intends to retire from the Board in January 2022.

We will vote undirected proxies **IN FAVOUR** of this resolution.

3. To re-elect Dr John Penno as a Non-Independent Director.

Dr John Penno co-founded the Synlait Group in 2000 and was a full-time executive for the Synlait Group from 2006 to 2018. In November 2018 he was appointed as a Board Appointed Director of Synlait. He chairs the Pure Food Co. Limited and is a director of Okuora Holdings Limited, Thorndale Dairies Limited, and Leaf Foods Limited. He is also Chair of the Fresh Water Leaders Group reporting to Ministers Parker and O'Connor.

We will vote undirected proxies **IN FAVOUR** of this resolution.

4. To amend the Constitution.

The company proposes an amendment to the Constitution to enable the Chair of the Board to be either an Independent Director or the Board Appointed Director for a limited period up until the next Annual Meeting to be held in 2022. Currently the Chair can only be an Independent Director.

This is to allow Dr John Penno to be appointed Chair on the retirement of Graeme Milne as explained above.

We will vote undirected proxies **IN FAVOUR** of this resolution, on the basis that it is a short-term solution to a current issue. We continue to advocate for change to the company's underlying governance structures.

Proxies

You can vote online or appoint a proxy at <https://www.investorvote.com.au/>

Instructions are on the Proxy/voting paper sent to you.

Voting and proxy appointments close **1.00pm Monday 29 November 2021.**

Please note you can appoint the Association as your proxy. We will have a representative attending the meeting.

STANDING PROXIES - AUTOMATICALLY APPOINT NZSA AS YOUR PROXY

MAKE YOUR VOTE COUNT!

Details on the NZSA website.

<http://www.nzshareholders.co.nz/shareholders-standing-proxies.cfm>

The Team at NZSA