"A BETTER DAIRY DEAL": HANDBOOK FOR NEW ZEALAND DAIRY FARMERS

www.dairynz.org

5 June 2001

LETTER TO DAIRY FARMERS

5 June 2001

Dear *friends and colleagues*

Very shortly, we will decide our future – for at least the next 10 years. It certainly is a major decision.

For many farmers, there is a sense that "the die is caste. Like it or not, we've got Global Co – there's no other choice".

I don't believe that's true. There *are* better practical options.

In making such an important decision, it is essential that we consider the options.

Many farmers and colleagues share my concerns about the process and the problems with Global Co. We realised we had a duty to make sure farmers are given an opportunity to consider properly the options before voting on 18 June.

So we have formed 'Farmers for a Better Dairy Deal'. Our aim is to set out the options in a fair and balanced way, looking at the pros and cons from both views.

My personal conclusion, after going back to the basics, is that Global Co won't do it for us. It's not the right solution. Having one group own everything (including us if we want to sell milk) is not common-sense and it's not business-like.

I know a lot of you share my concerns, but haven't voiced them publicly.

Many of you feel that while Global Co has its problems, at least it is something – no one wants the status quo.

Nor do I.

But we can do a lot better than Global Co. I invite you to consider the alternatives set out in this paper with an open mind.

If Global Co does not proceed, the sky will not fall in. One of the better options will emerge very quickly.

And this better option will be driven by straightforward business principles, not politics.

Our business interests will be put *first*, ahead of other agendas.

The horrible internal politics that has bogged down our industry for so many years will be forced to the back seat.

I urge you to vote ‘no’ on 18 June. It’s a vote for a better option.

Yours sincerely

Mark Masters
Past Chairman
Dairy Farmers of New Zealand Inc

THERE IS A BETTER CHOICE

www.dairynz.org

“Global Co is a political deal to fix a stalemate between Kiwi and NZ Dairy Group over who controls the Dairy Board……

…It’s not about business or maximising returns for farmers.”

IMPORTANT NOTICE

'Farmers For A Better Dairy Deal':

- Is **not** affiliated to any political party, business or lobby organisation ; and

- **Has not and will not** receive any funding or financial assistance from any political party, business or lobby organisation;

- Is a group of concerned individuals who have similar views in relation to the Global Co proposal; and

- Will meet any financial expenses incurred in this process from participants' individual, voluntary contributions.

Mark Masters and Hilary Webber have formally asked Kiwi and NZ Dairy Group respectively to send to all NZ dairy farmers a copy of this Handbook and the accompanying material to be issued by us shortly.

As a group, we focus on the **quality of ideas**, not the politics or the office of the person offering those ideas.

SUMMARY

- Our aim is to maximise returns over time for farmers' on their investment in the New Zealand dairy industry.
- Global Co is not capable of delivering on the industry's growth and diversification strategy.
- Outside share capital will be required to grow the value-added and consumer businesses – which have the high margins and high risks.
- To succeed in these high-margin markets, the business must be demand-driven, not production-driven as it has been for the last 80 years. It must be agile and highly commercial.
- Outside capital will also be required to buy foreign milk factories.
- Each farmer must be able to choose individually whether to invest new share capital in overseas milk factories and risky high-margin products.
- Global Co does not provide these essential requirements.
- In 1999, McKinseys' advice to industry leaders was absolutely clear. A single co-op for the whole of NZ is not as good as two competing co-ops *unless* it has eight vital safeguards.
- Those eight vital safeguards have been left out from Global Co (or seriously watered-down) (refer to Appendix 1).
- If we want the growth and diversification strategy, the structure must follow. The value-added and consumer businesses cannot be delivered by a traditional co-operative. We can't avoid reality.
- Our real competitors have changed and moved forward. We need to as well.

IF WE WANT THE STRATEGY,
WE HAVE TO
VOTE 'NO' TO GLOBAL CO

www.dairynz.org

REASONS

Key objectives

- The key issue for dairy farmers is, what structure will promote maximum sustainable returns for us when the Government removes the Dairy Board's 'single desk' powers?
- This Handbook outlines the key elements of a **'Better Dairy Deal'**.
- Each key point is explained in more detailed in the accompanying Appendices.

Main problem with Global Co

- Global Co won't work. Put simply, it is not capable of delivering the industry's growth and diversification strategy.
- The fundamental question for farmers is this: are we serious about building our value-added and consumer businesses – as recommended by McKinseys in 1999?
- If so, it will need:
  - A lot more share capital – *much* more than we can muster among ourselves;
  - A different commercial structure – one that is highly responsive, agile and innovative; and
  - A strong consumer-orientated culture, free of the ridiculous supplier politics that has been bogging us down.
- High end, consumer businesses must be demand (ie consumer)-driven, not production-driven as we have been for the last 80 years.
- Without more share capital, a commercial structure and a demand-driven culture, our high-end businesses will fail. Simple as that!
- Global Co can't deliver these three vital ingredients. It is like asking a person with no legs to walk.
- As sure as night follows day, structure must follows strategy.

- But in Global Co, it's all been back-to-front. Our leaders have become so bogged down in the politics of a traditional co-operative structure, they have haven't asked if it can deliver the strategy.

- The answer is, no it can't.

Industry politics

- A lot of dairy farmers simply don't want to hear this. It goes against 80 years of belief and experience in traditional co-ops.

- And because that, our directors – who rely on our votes – don't want to tell us.

- Some have and they've lost their jobs.

- But if we want to build our value-added and consumer businesses, we can't use a traditional co-operative. They're just not designed to do it.

- Our European competitors have realised this and set up new commercial structures (some of them are called '3rd Generation Co-ops' or 'Hybrid Co-ops'). They have many features of an 'investor owned company'.
- We have to do the same. A round block won't fit into a square hole – end of story!

Experts agree

- *All* the experts agree that operating just one major dairy company for all of NZ has major risks.

- The risk of a Global Co being inefficient are high – even McKinseys – the industry's leading advisers – acknowledge this.

- McKinseys agreed with a Mega Co-op for NZ **only** if eight safeguards were put in place. McKinseys described them as 'absolutely essential'. Without them, McKinseys preferred two competing firms.

- Global Co *doesn't* have several of the McKinseys essential safeguards (refer to Appendix 1).

- Global Co won't have a monopoly on good ideas. But Global Co will hold access rights to quota markets, and large scale competitors will not enter for at least for three years.

Vote 'No'

- Voting against Global Co is the not only right thing to do – it's also a very positive option – <u>and</u> it will significantly reduce your risk of loosing money!

- Whatever we do, it must be consistent with the general law, including normal competition law. So we should say to the Government, “we **don’t** want an exemption from the Commerce Act. If we are going to form a single company, we want to show that its benefits are greater than its disadvantages”.

- The Commerce Act is a good protection for us as farmers and NZ consumers.

- The formal process can also be completed in 60 working days.

<u>'Critical mass'</u>

- The Commerce Act is not a barrier to us achieving 'critical mass'.

- In fact, Global Co doesn't really increase our critical mass. The merger is not creating any new share capital, which is what we need to grow.

- Global Co is a barrier to growth because it can't get outside share capital.

- Over the coming years, it is likely that NZ farmers will peel-off from Global Co – so it's equity base in NZ is likely to shrink.

- NZDG and Kiwi are just as capable of buying or merging with businesses in Australia (or where ever) as Global Co.

- If we had two competing co-ops, chances are both would be NZ controlled.

- With Global Co, it's highly likely that any major competitors will be foreign.

Better Options

Summary

- Several options are better than Global Co. But we are focusing on three.
- The primary objective is to create a structure that can deliver the strategy, in a manner that does not overall destroy value in the Dairy Board.
- All the parties would have to comply with general business law in New Zealand, including the competition laws. There would be no Government exemptions.
- The three better options we have focused on are:
  - **Option 1:** Dairy Board continues with commodities and basic ingredients; a new company is established for growing value-added businesses; and Kiwi and NZDG do not merge, but continue to compete in NZ.
  - **Option 2:** One of the big co-operatives sells its shares in the Dairy Board to the other.
  - **Option 3:** The 1999 Mega Co-op proposal, but with the details set in concrete.
- A period, fixed in legislation, would be allocated for NZDG and Kiwi to agree on an option better than Global Co.
- If agreement were not achieve within that period, a special resolution process would apply.
- This regime will ensure that a robust commercial solution is established, rather than one like Global Co, which is driven by industry politics.

Option 1:

Dairy Board for commodities + corporate for value-added business + Kiwi and NZDG competing for NZ sales

- **A new corporate would be created for value-added and consumer businesses.**
  - It would be a normal public company.
  - At least 51% of its shares would be held by NZDG and Kiwi jointly.
  - The remaining 49% would be held by dairy farmers.
  - 'NZ Milk' – one of the Dairy Board's business units – would be its initial core business.
  - A prospectus would be issued seeking new share capital from any investors (including farmers).
  - Shares in this business would be tradable and eventually listed on the Stock Exchange.
- **NZ Dairy Board for commodities and ingredients business.**
  - The NZ Dairy Board would continue as it is now – an exporting co-op owned 58% by NZ Dairy Group and about 35% by Kiwi;
  - However, all the Dairy Board legislation would be removed and the co-op shareholders would put in place a proper constitution for the Dairy Board.
  - All the special Government regulations to be put in place around Global Co would not be necessary.
- **NZDG and Kiwi continue to compete in NZ as they do now.**
  - NZDG and Kiwi would *not* merge.
  - Commercial supply agreements would be put in place between the Dairy Board and each co-operative.

Option 2:

Two competing co-ops

- Under this option, one of the two big co-ops would sell its shares in the Dairy Board to the other big co-op.

- The selling co-op would take the cash and invest it in new businesses following its own strategy.

- An obvious option for the selling co-op would be to buy into a strong dairy marketing company.

Option 3:
Mega Co-op for commodities +
corporate for new value-added business

- In essence, this is the 1999 Mega Co-op plan.

- It is very important to realise that Global Co 2001 is *not* the same as Mega Co-op 1999. The key differences are set out at the front and back of this Handbook.

- For Mega Co-op to work, the special features of the 1999 plan would have to be set in concrete (and probably expanded) before going to the Commerce Commission.

- Last time, the special features were only suggested to the Commerce Commission as a possibility, so the Commission could not really factor them in.

- It would be vital to ensure in the structure that NZ Dairy Foods could access basic products from Mega Co-op on a proper commercial basis and compete effectively in NZ.

Key Question: Many farmers are probably now asking:
"How on earth do you make one of these
better options happen? Industry politics will turn it all to custard!"

Clear boundaries are required:
Fixed Timetable and Special Resolution Process

- The directors of the two big co-ops would have a fixed time within which to agree on the better package.

- The fixed time would be set in legislation.

- If the co-ops do not reach agreement within the fixed time, a special resolution process would apply. It would also be set out in legislation.

- One co-op would *have* to make an offer to buy all of the other co-ops shares in the Dairy Board within another fixed period.

- Within a certain time of receiving the offer, the other co-op have to **either:**
  - Sell all of its Dairy Board shares to the other co-op at the offered price; **or**
  - Buy all of the other co-op's Dairy Board shares at the offered price.
- The price offered will therefore have to be extremely realistic, given that the co-op receiving the offer could use it to buy all of the other co-op's Dairy Board shares.
- This resolution process is tried and proven in a variety of partnership situations.

Key advantages

- The process to decide and adopt a better option would be driven primarily by business considerations, not politics. The main driver would be: "Get a structure that will deliver the strategy".
- It would be completed with a fixed period. No more mucking around with our money and time.
- The structure between farm-gate and factory would continue as it is now.
- And it would ensure that current value in the Dairy Board – including intangible assets – are not just preserved but grown in value.

Global Co's Pros + Cons

GAINS FOR FARMERS

- Replaces 'single desk' (**$20 m** gain)
- Keep traditional co-op principles (no $ value)
- Vertical integration of manufacturing and marketing [**$15m gain**] but can be achieve better ways.

LOSSES FOR FARMERS

- Loss of innovation [**$325 million** per year]
- Inefficiencies from being a near-monopoly (**$192 million** per year]
- No effective benchmarking
- No farmer control over investments
- Focus on playing regulatory 'games', especially trying to stop competitors
- Weak controls over management
- Can't respond to changing consumer-demands quickly
- o-operative principles not sustainable with industry strategy
- Delay in introducing essential new share capital
- Misuse of NZ's scarce resources for another 5 years at least
- "All eggs in one basket"

Commerce Commission valued total gains at **up to $56 million** per year

Commerce Commission valued total losses at up to **$527 million** per year

ANALYSIS & ADVICE

- **Results of analysis**

  You may find this surprising, but ALL the experts and advisers – on both sides of the fence – agree that growing the two big co-ops would be better than collapsing them into one – better for us and NZ as a whole. You say this is wrong? Have a look at Appendix 2**,** which summarises the advice of all the main advisers.

- **Who believes two is better than one?**

  - The McKinsey study of 1999 commissioned by the industry;
  - The Promar International report of 2001 commissioned by MAF;
  - The Commerce Commission in its Draft Determination of 1999;
  - Various reviews by Professors Quigley and Evans commissioned by the Government; and
  - All of the senior Government officials, as set out in Government papers released under the Official Information Act.
  - We understand that several senior dairy leaders, some Government Ministers and some senior dairy officials also have strong reservations about Global Co, but for various reasons they are not able to state their position publicly.

CONCLUSION

“Will Global Co grow my wealth more effectively over the next 5 years than the alternatives?”

- Sadly, the answer is no – the structure can’t deliver on the promise.
- Global Co is simply a political deal to fix a stalemate between Kiwi and NZ Dairy Group over who controls the Dairy Board. It’s not about business.
- Let’s vote to thrive and prosper.
- The alternatives outlined in this Handbook can deliver.

BE POSITIVE

VOTE ‘NO’
TO GLOBAL CO

www.dairynz.org

DIFFERENCES BETWEEN 1999 MEGA CO-OP + 2001 GLOBAL CO

FEATURE	2001 GLOBAL CO	1999 MEGA CO-OP
Commerce Commission approval required	No	Yes
Extra $4 billion of new share capital from non-farmers	Promoters say no, but probably yes	Yes
Separate 'A' shares for commodities business	No	Yes
Separate quota shares ('Q' shares) for farmers	No	Yes
Trading of 'A' shares among farmers within band of 80-120% of supply	No	Yes
Farmer choice to invest in new overseas ventures	No	Yes
Separate vehicle to for new overseas consumer-market ventures	No	Yes
How easy for a supplier to pull out capital?	Hard	Easier
Government regulations and regulator	Yes	No

‘A BETTER DAIRY DEAL’ - INITIAL GROUP

NAME	CURRENT OCCUPATION	INDUSTRY INVOLVEMENT	CONTACT DETAILS
Dairy farmers			
Mark Masters Main spokesperson	Dairy Farmer, Taranaki	President, Dairy Farmers of New Zealand, 1999	(06) 765 7544
Malcolm Bailey	Dairy Farmer, Manawatu	President, NZ Federated Farmers, 1999	(06) 323 8147
Hilary Webber	Dairy Farmer, Waikato	Past Director, NZ Dairy Group	
Tom Mason	Dairy Farmer, Taranaki	Shareholder-supplier	
Rob Poole	Dairy Farmer, Taranaki	Shareholder-supplier	
Stephen Poole	Dairy Farmer, Taranaki	Shareholder-supplier	
Mr R C Cole	Dairy Farmer, Mataura	Shareholder-supplier	
David Russell	Accountant, New Plymouth	Accountant to many farmers	
Rob Thompson	Dairy Farmer, Canterbury	Shareholder-supplier	
Bruce Davies	Dairy Farmer Waikato	Supplier representative	
Hank Weijers	Dairy Farmer Waikato	Supplier representative	
Gordon Kirkham	Dairy Farmer, Cambridge	Supplier-shareholder	
Kevin Mayall	Dairy Farmer, Hamilton	Supplier representative	
Wellington-based			
Ian McIntosh	Industry Advisor	Adviser with Agriculture New Zealand.	(04) 463 5535
Gareth Morgan	Economist	Managing director, Infometrics	(04) 473 0630

Quentin Hay	Commercial Barrister	Adviser to the Producer Board Project Team (PBPT) 1999	(04) 473 8733
Stephen Franks	Commercial lawyer + Member of Parliament	Legal adviser to NZ dairy industry, 1999	(04) 471 9999
Tony Baldwin	Retired	Leader, Producer Board Project Team, 1999	(03) 527 8121
Geoff Sinclair	Commercial Manager	Adviser in PBPT, 1999	(04) 473 5240

A range of other well-informed individuals strongly agree with ‘A Better Dairy Deal’ but for reasons of personal privacy are not able to appear on this list.