Country-Wide

FONTERRA's FIRST YEAR

April 2002

By Tony Baldwin

A blow-out in corporate overheads. Very high salaries. 3500 missed milk collections in a month. 100% too much working capital. Too much money tied up in fixed assets. Inventory levels too high for too long. $73 million in consultants' fees. Lack of direction at the top, forcing the best commercial director to resign. 'Powdergate' still hovering in the shadows. And to cap it all off, Fonterra's main business (NZMP) earned just 3% *before tax* on shareholders' equity. You could put your capital on a bank term deposit and earn more.

All in all, a not a good look for Fonterra in its first year. So how bad is it, really?

Unfortunately, most readers will believe only what they want to believe. Most dairy farmers *want* to believe that Fonterra is the right way to go.

I will do my best to give you an objective assessment.

Good dairy farmers focus mainly on making their farm hum, with the aim of producing more milk of good quality as efficiently as possible.

Fonterra's job is to turn your milk into money.

Co-op shares are, in effect, your guarantee that (so long as the tanker turns up) all the milk you produce will be collected, processed and put out for sale, with the net proceeds coming back to you in a milk payout. This sense of security is why you support the co-op model.

Right now, however, you will be feeling let down by Fonterra's high salaries, cost over-runs and sloppy systems.

What went wrong?

First and foremost, dairy leaders grossly *over-promised* what Fonterra could deliver. They promised a new world, a new era of riches. Expectations were raised to unrealistic levels. Disappointment was inevitable.

In reality, the mega-merger did not change things in a major way from the Dairy Board regime. It integrated Kiwi and NZDG factories, but the rest of the core structure is much the same as before. The Dairy Board formed NZMP and NZ Milk. The Dairy Board developed commercial pricing and the CMP. And the Dairy Board did the spade work on the Nestle alliance.

Apart from integrating domestic processing plant, what has changed is the quality of information you now receive. Thanks to the Shareholders Council, you now get more performance analysis.

Many weaknesses identified in relation to Fonterra have in fact been in the system for many years, but they have been buried. For example, the problem of having too much capital tied up in stainless steel started well before Fonterra's formation.

Henry van der Heyden's challenge now is to free up some of that capital.

Responsibility for employing $1.5 billion of working capital more than is efficient can not be passed back so readily to the legacy companies. Nor can the problem of NZMP failing to cover Fonterra's commodity milk price.

Across the board, Fonterra's costs are too high. Its payout should have been 39 cents/kg MS higher.

Whether a company or a co-operative, monopolies are by nature inefficient. Unless Fonterra believes that you *will* withdraw in large numbers, taking the full value of your investment with you, it will be very hard to keep Fonterra honest and efficient, year on year.

In 1999, McKinsey's issued your leaders a stern warning about the risks of the mega-merger becoming inefficient. One of McKinsey's 'must do' recommendations to counter this risk was that Fonterra should be required to deliver every year 4% real productivity gains, with serious penalties for managers if they failed.

This 4% rule was dropped in the merger negotiations. Kiwi directors did not like it and McKinsey's withdrew their threat to walk away from the deal if any of their preconditions were not satisfied.

Craig Norgate started his job saying Fonterra would achieve the Commodity Milk Price for suppliers It now turns out that the gap between Fonterra's actual payout and the CMP is 39 cents/kg MS (or $430m). Craig's public view of the CMP seems to have changed as a result, now describing it as an 'aspiration'.

Henry van der Heyden will need to enforce strong measures to close the $430m gap.

Turning to the 'fair value' share price, which Fonterra has set at $3.85. Three problems stand out.

(When reading what follows, keep in mind that the share price is based on the earnings retained by Fonterra, not what it pays out in the milk price).

The first problem is that $1.30 of the $3.85 is based on Fonterra banking $172m in merger savings. So far, it claims to have achieved about $80m. However, Fonterra says half the $80m should be credited toward the milk payout. This leaves around $40m to credit toward the share price.

In short, Fonterra has banked about $40m of the $172m savings assumed in the share price. The key question is then, will Fonterra deliver the remaining $130m or so? If not, farmers buying shares now at $3.85 could lose real money.

The second problems is that non-tradable shares are normally discounted by about 50% relative to shares that are fully tradable. However, Fonterra only allowed a discount of 10%.

If we adjust the 'fair value' for these two factors, it would be closer to $1.80, just under half the $3.85 set by Fonterra.

The third problem is that Fonterra's $3.85 share price does not appear to reflect properly Fonterra's expected net earnings, particularly in NZMP which are not strong.

All of this highlights just how artificial the 'fair value' mechanism is. The boundaries between share price and milk payout are blurred. The share price can be altered significantly by simply changing the milk payout policy. In short, the 'fair value' share price is vulnerable to arbitrary and questionable judgements by Fonterra.

Part of the problem is that the 'fair value' mechanism actually has two roles. One role is to influence milk flows. (A higher share price will slow milk growth, but it will also make suppliers wanting to expand rather grumpy).

Its other role is to allow shareholders to withdraw their investment in Fonterra at near to market value. Of course, a high share price and low payout will only encourage suppliers to cash up their shares, especially if a competitor can offer a comparable milk payout.

Fonterra can play some interesting games in trading off these interests.

Peak notes are also relevant, but beyond the scope of this article. Suffice to say that the peak notes mechanism has not been designed properly. Kiwi did not want it, NZDG did. The result is a muddled and ineffective compromise.

Turning back to Fonterra's financial statements. In summary, we see that:

- Fonterra is a relatively basic commodity business, which is not particularly efficient. Much of its inefficiency was inherited from the legacy companies.

- Fonterra started life in the 'summer' of high prices and a low NZ dollar, but finished its first year in the 'winter' of low prices and a high NZ dollar. While the industry's PR machine at the time tried to have us believe milk was 'white gold', Fonterra's 'summer' was, when viewed in an historical context, rather a short term blip.

- Fonterra controlled its manufacturing costs, but failed to control its other costs.

- Fonterra did not add economic value for shareholders.

- Fonterra's balance sheet is significantly weaker than expected. Shareholders 'own' only 28% of Fonterra's tangible assets. Its ability to raise new capital is therefore not strong.

- NZ Milk performed substantially better than NZMP. However, NZ Milk's returns are still significantly weaker than its competitors. NZ Milk is targeting products with higher margins, but these also involve higher risks. Despite industry PR to the contrary, the Dairy Board did not have a happy time trying making money in the value-added area.

- Fonterra claims to have banked $74m in merger benefits. However, it is evident from the Shareholder Council's report that this is very woolly territory. Such claim should be audited independently.

Where does this leave Fonterra and its suppliers? At a cross-roads.

As suppliers and shareholders, you face the simple yet fundamental decision of what you want Fonterra to be.

If you want Fonterra to guarantee the collection, processing and payout of all the milk you produce no matter how much, and you want it to be owned *exclusively* by NZ dairy farmers, Fonterra has only one possible role – to produce basic commodities on a large scale for sale in developing countries. Despite PR spin to the contrary, Fonterra is largely a price-taker in these markets.

Under this role, Fonterra is production-driven. It is the way things have been for many years. Real payouts and commodity prices are steadily declining. Milk volumes are steadily rising. Production and processing costs per unit are steadily falling.

If this is what you want, Fonterra *cannot* be a serious player in new product markets involving pharmaceuticals, specialty dairy foods and high value ingredients. It simply does not have the necessary capital, expertise or culture.

A successful value-added business needs to be able to control the volume of milk solids it buys. Capital is more valuable than milk. The business is driven by consumers, not suppliers.

Right now, Fonterra is in no-man's land. It is not an efficient commodity producer. Nor does it have the elements necessary to grow a successful value-added business.

Behind the scenes, your directors are grasping for a clear direction. They are in a bind – torn between 'keeping the faith' with you as suppliers, on one hand, and opening up new horizons to capture wealth for you as shareholders, on the other hand.

I suspect many of the directors would like to say to you: "Fonterra is a beginning, not an end. The co-op model has served us well, but we are entering a new world. We need a new approach if we are to realise our full potential."

But they won't. They are afraid of loosing your confidence, even though it is what many of them honestly believe.

Until this core question is resolved, Fonterra's problems will remain. Your directors will put on a brave face, but they will stay stuck in a knot.

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23 September 2002