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Fonterra reveals the high cost of emotion triumphing over reason

By Tony Baldwin*

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Recent boardroom ructions have once again put New Zealand's largest company, Fonterra, under the spot-light.

When top-notch director, Mike Smith, resigned citing fundamental concerns about mediocrity and likely under-performance, Fonterra's supporters circled the wagons, while critics found it hard to disguise their sense of told-you-so vindication.

Neither response is helpful. Those who can see past the Fonterra hologram need to focus on helping to find solutions, so Mike Smith's fears are not realised.

Fonterra desperately needs three things:

- the same performance pressures that drive its overseas competitors, Kraft, Nestle, Parlmalate and Danone;
- a culture of openness and innovation; and
- real leadership.

Without question, Fonterra faces stiff competition in international markets. But the acetylene torch that fires and disciplines managers' performance is fueled by more than one gas.

Effective shareholder scrutiny and choice is essential if the flame on management is to have real potency.

Successful firms with a large number of widely dispersed shareholders use mechanisms that try to proxy the levels of accountability and scrutiny found in smaller firms.

The normal solution is to provide detailed financial information on a regular basis to a wide range of outside analysts, who assess it independently for possible changes in the company's future earnings potential. Shareholders are then free to buy and sell at any time, based on market perceptions of expected value changes. While not perfect, it is a well tested process and considerably better than a company with fragmented ownership operating without it.

However, the dairy industry has a profound distrust of these shareholder safeguards.

In voting for Fonterra, dairy farmers voted to hold on to their 100-year-old closed co-op model, even though Fonterra has 14,500 disparate and fragmented shareholders.

A contradiction, indeed, and a powerful example of emotion prevailing over reason.

Co-ops have been the back-bone of dairy farmers' sense of social and economic security, akin to a social movement, promoting values of equality among dairy farmers, mutual assistance, a complex political hierarchy and a strong sense of competing tribal identities.

Above all, the dairy co-op movement has been unified by a powerful collective fear that if their local processing factory were ever to be owned by non-farmers, prices for raw milk would be forced down. Because raw milk goes off within hours, dairy farmers assume they would have no choice but to accept artificially low prices from an independent factory owner

This overwhelming sense of vulnerability and distrust has shaped and encumbered the dairy industry's evolution.

To achieve its goals now, however, Fonterra needs several things its much-loved traditional co-op model cannot readily deliver, including:

- normal disclosure rules, as if it were listed;
- fresh management;
- a more expert and independent board;
- considerably more equity capital than farmers can provide;
- a separate company, with tradable shares, for its consumer business;
- mandatory requirements for annual efficiency gains; and
- new leadership, to promote a business governance culture that is open, innovative and confident.

Fonterra's current constitution prevents or impairs all of these things.
Fonterra is also bound by complex Government regulations of questionable enforceability,
Yet farmers still plumped for it, in their droves, opting in effect for closed farmer ownership in preference to effective accountability and governance.

Two years ago, dairy leaders were warned in the strongest possible terms by consultants, McKinseys, that a single mega co-op would *only* be better than two competing firms if safeguards were put in place to counter the serious risks of monopoly inefficiency.

Without these safeguards, McKinseys' analysis showed that two competing firms would be better than one by $300 million per year.

Are the stringent 'must do' safeguards in place? On the evidence available to farmers, the answer must be 'no', even though McKinseys boss, Andrew Grant, assured farmers before last year's merger vote they were. At that time, Mr Grant gave Fonterra an 8/10 for implementation of his preconditions.

Either Mr Grant has information farmers lack or he has significantly watered-down his earlier essential preconditions. I fear the latter. So do others who have reviewed McKinseys' 1999 report.

Not surprisingly, Mr Roadley and his pragmatic political colleagues opted for the path of least resistance. In the end, NZ Dairy Group did too, even though it had invested so much in preparing for open export competition with Kiwi.

After a series of quickly executed internal coups, NZ Dairy Group capitulated and agreed to Kiwi's lowest-common-denominator merger terms.

Laws that apply to all other parts of the economy were overridden. The industry's small crop of top directors were discarded, including Messrs Storey, Fraser, Allison, Fernyhough and most recently Smith, all with grave reservations.

These costs cannot be simply dismissed as unavoidable collateral damage. Had Fonterra been a new Clyde Dam, the country would have been in outrage. However, because it is less tangible monolith somewhere down-country, the wider community has been unaware, disinterested or mute.

Some cynical observers know Fonterra is suboptimal, but they put a higher value on securing deregulation. In their view, pushing for effective competition and good governance too risked loosing that prize.

With stronger leadership, however, much more could have been achieved. Better options were available.

Even leading advocates of the co-op movement abroad acknowledge that the co-op as an organisational form is in retreat. It is struggling to adapt to more complex, capital intensive, consumer-driven business activities. The removal of special Government supports, such as exemptions for co-ops from anti-monopoly laws, is accentuating their demise. Advocates have called for new Europe-wide legislation to rekindle participation in co-ops.

A key rule of business is that structure follows strategy. The Fonterra process illustrates how the dairy industry tried to reverse the rule. Adherence to a traditional co-op model is treated a large part of the industry as an immutable law of nature. This rigidity of thinking, combined with failure of leadership, has cost New Zealand dearly.

The transition from Fonterra to better adapted business organizations, suited to meeting consumer-demand more efficiently than their competitors, will be expensive. With sound leadership, much of these economic costs could have been avoided.

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