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Forget the spin, show shareholders the money

By Tony Baldwin*

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Over recent weeks, Fonterra has announced several major alliance, joint venture and direct investment deals in the Americas, India and Britain. Two main features have been highlighted: the size of the markets and the size of the joint venture partners.

The question that counts, however, is whether the deals are likely to be good for Fonterra's shareholders.

As a strong critic of Fonterra's formation, some may assume that I would be predisposed to a negative view. This is not the case. Quite the opposite, in fact. The decision to establish Fonterra has been made. Now it needs all the help it can get to succeed. Fonterra's performance is critical, not only to its 14,000 shareholders, but to the NZ economy as a whole.

Information released by Fonterra to shareholders so far has been scant to say the least. Indeed, it is hard to tell how each deal works. Shareholders have been given no indication of likely costs, risks or returns.

Based on information obtained to date from senior Fonterra sources, the picture to emerge at this stage is that Fonterra will buy and operate Nestlé's dairy factories in the Americas. Nestle will not necessarily buy product from Fonterra's factories. Nestle wants to exit this commodity level of the business, which is not its strength. Managing milk is a relatively low margin activity.

For its part, Fonterra will inject about another $600m. This capital could otherwise be returned to NZ farmers. However, farmers will not be given a choice, such is the nature of a closed co-operative.

In essence, Fonterra will become a larger raw milk manager in the Americas. This certainly falls squarely within Fonterra's core competencies. Fonterra's CEO, Craig Norgate, built his reputation efficiently processing large volumes of raw milk.

However, under its draft constitution, Fonterra's principal activity is to deal with NZ milk. The question then arises, where is strategic rationale for these new overseas deals, which seek to grow Fonterra's investment in non-NZ dairy products?

Trying to find an answer has been unexpectedly difficult. As it turns out, Fonterra has yet to put in place an authoritative and consistent statement of its strategic goals and business plan.

For now, the directors seem to be following a largely pre-determined path, implementing initiatives inherited from the Dairy Board or agreeing to run with new opportunities on an ad hoc basis.

This lack of a coherent strategy, and the directors' weak understanding of likely costs, risks and returns, are key reasons I would surmise why top notch director, Mike Smith, resigned from Fonterra earlier this year.

Fonterra seems to have five agreed goals: (i) to extract value from milk produced in NZ; (ii) to realise $320m of efficiency gains; (iii) to maintain unity and scale in the NZ industry; (iv) to preserve co-operative principles; and (v) to ensure exclusive ownership and control by NZ dairy farmers. Whether these are strategic or 'political' goals is open to debate.

The uncertainty arises in relation to Fonterra overseas growth plans. There seem to be several competing views:

To Chairman John Roadley, Fonterra's number one objective is to ensure that the NZ industry continues to be owned and controlled exclusively by NZ dairy farmers. On the question of overseas investment, Roadley is vague. Somehow, Fonterra is to remain exclusively owned by NZ dairy farmers within a traditional co-operative, yet also grow dramatically to become the preferred supplier of dairy products to the largest global retailers. Roadley has pointedly, and I believe wrongly, dismissed the role of small, high-margin boutique dairy businesses dealing with emerging global retailers.

To Chief Financial Officer Graham Stuart, Fonterra is three things: *"We are a dairy farmers' co-operative. And we are a multinational marketing company. And we are also an international capital investor".*

To CEO Graig Norgate, Fonterra's plan is "*to launch an aggressive strategy of acquisitions and joint ventures, to earn the status of one of the world's leading multinational dairy companies."*

To former Dairy Board chief, Warren Larsen, Fonterra's strategic goal is simple: *"We must become one of the top five dairy food businesses in the world within five years."*

To McKinsey & Co's, the NZ dairy industry should, over the next 10 years, raise a further $12 billion of capital, grow annual revenues by 15% each year (from $10 to $40 billion), *and* earn annual returns on total gross assets of 15%. Under McKinsey's 1999 plan, most of this growth is to come from valued-added activities, such as new biotechnology products and specialised ingredients.

So, how do the Fonterra directors see it as board? Their answer for now is 'Project Galileo', a process they have put in place to formulate Fonterra's strategic goals and business plan. And *voile*, the project is to be lead by McKinsey & Co, reporting back in August.

Now a diligent director would indeed ask, how can Fonterra commit to such large overseas decisions in advance of completing Project Galileo? Several Fonterra directors did raise this question, but were overruled. Remember, this is a relatively inexperienced board and the industry has a long tradition of director deference to management.

Fonterra needs to decide urgently what it wants to be in five years:

It could keep concentrating on commodity products (milk powders, butter, basic cheeses), which is a low margin business, with opportunistic growth in dairy ingredients, using mainly NZ milk. While the Dairy Board had a strong track record in these areas, its more recent moves into many consumer products been of dubious profitability.

Or Fonterra could 'stick to its low-margin knitting', but apply its skills to milk produced overseas in growing markets like Asia and South America.

Or Fonterra could follow the path of Kerry Group, a traditional Irish dairy co-op that decided in 1982 to reduce its reliance on dairy commodities and rapidly grow its revenues from higher value specialised food ingredients and branded consumer products. These include dairy and non-dairy products such as seasonings, coatings, flavours and additives involving meat, fruit, spice, cereal, nuts and dairy.

To implement its strategy, Kerry needed a large increase in share capital, which was beyond the resources of its farmer-suppliers. So in 1986, Kerry converted to a listed public company with shareholder funds of 40m Irish pounds. 15 years later, Kerry's shareholders' funds have increased in value to 1.25 billion Irish pounds.

Or Fonterra could follow Nestlé's dairy path and concentrate primarily on highly differentiated branded products. 35 years ago, Nestle and the NZ Dairy Board had similar earnings per share (or payout per kilo of milksolids). Since then, Nestlé's earnings have increased about 80 times, while the Dairy Board's payouts have remained relatively static In real terms Dairy Board payouts have actually declined. Two quick points of comparison between the Nestle and the Dairy Board (estimates as at 1999).

	NESTLE	NZ DAIRY BOARD
Employees	230,000	9,800
Sales	US$45 billion	US$3.3 billion

So, what conclusions can we draw from all of this?

First, it is not clear if Fonterra's recent overseas deals will be good for shareholders. The information disclosed so far is inadequate. Fonterra needs to explain properly how the Nestle deal is to work. Hopefully, it will be better for Fonterra than has been suggested so far.

Second, NZ dairy farmers should not be forced to commit their capital into higher risk overseas milk processing. Fonterra should issue a prospectus for these activities and seek fresh equity funds.

Third, it is likely that many of Fonterra's directors do not fully understand the range of likely costs, risks and returns relating to the new overseas deals.

Fourth, Fonterra's recent overseas deals do not appear to fit into any coherent strategic plan as Fonterra's directors have yet to formulate one.

Fifth, Fonterra is still medium-sized by world dairying standards. Nestlé's dairy business alone is 2.5 times larger. Dean/Suiza in the USA is twice as big. Fonterra's key competitors can also continue to grow using outside share capital. As a traditional dairy co-operative with a highly constrained equity based, Fonterra's funding base is limited.

Sixth, Fonterra's traditional co-op structure will preclude it from becoming a diversified dairy foods business.

Seventh, will Fonterra's directors know how to avoid the mistakes of many other NZ companies which have looked for growth by investing in large overseas businesses? Our track record is not good. Air NZ's purchase of Ansett was the last attempt by a NZ firm to go behind trade barriers lines.

And finally eighth, Fonterra's prospects are seriously weakened by the lack effective disclosure, monitoring and on-going market valuation.

It is time for Fonterra's directors to pull out a wider and more detailed road map. They also need to get their horse in front of their cart.

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