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Change the date and ... a Fonterra new strategy

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On presenting the 2002 strategy two days ago, Fonterra's chairman and CEO said that Fonterra started with a "blank sheet of paper" which has lead "[f]or the first time in our history [to] a strategy which focuses all our efforts on building on the strong foundations we have in Fonterra".

In other words, Fonterra's 2002 strategy is supposed to be fresh, new and historic.

Fonterra says it paid McKinseys $3-4m for this 'new' strategy.

Using publicly available sources, I have compared the 2002 strategy with the one developed by McKinseys for the industry in 1999.

The 1999 strategy was adopted by a Joint Steering Committee of industry leaders and was presented as the *raison d'etre* for the merger of Kiwi, NZDG and the Dairy Board.

The 1999 strategy is reported to have cost $5-10m.

What does the comparison show? In summary, the two strategies are almost identical. 2002 is remarkably similar to 1999 *(see the table below)*. What value has the 2002 strategy added? It is hard to tell.

The differences seem to be negatives rather than positives. These include:

- 'Softer' language in 2002, with more references to "understanding our customers' needs", "co-operative principles" and "co-operative cornerstones" – though the strategy does not define these at all. The boundaries of the core co-operative business are still not clear.

- No discussion at all in 2002 of likely structural implications. The 1999 package had two parts: one on strategy, the other on structure. The 2002 document is completely silent on how the strategic 'themes' are to be achieved. It is also silent on the implications the 'themes' may have for Fonterra's structure.

- 2002 has no explanation of how the strategic 'themes' are to be weighted. Where is the growth to come from: core commodities or value-added? In what proportions?

- 2002 also fails to recognise inherent conflicts within the strategic 'themes'. Fonterra's existing core commodities business requires a very different mix of skills, culture and capital to the proposed food-services, foreign milk, and specialised ingredients businesses.

- The 2002 process probably managed stakeholders' likely reaction more carefully. In particular, Fonterra has gained from the Shareholders Council a sense of ownership for the strategy, even though its potential implications are probably not clearly understood by many farmers and Council members.

In short, the 2002 strategy, as released to shareholders, is general and vague. It is like a political *communiqué* that can mean different things to different readers.

It is certainly *not* new. Fonterra should restrain its long habit of over-hyping. It simply lacks credibility.

The dairy industry has been saying the same thing for many years without finding solutions. Since the mid-90s, industry leaders have recognised the threats to and limitations of their business. Back in 1989, Sir Dryden Spring said the industry's core strategy for the 90s was to sell only value-added products, or "as close to 100% as we can get as soon as possible".

The following analysis should sound familiar:

"The consolidation of retail has resulted in fewer, bigger buyers, all requiring a different bundling of services. Our opportunity is that we should be able to combine our size and brand name with the right services, such as category management and packaging, to work with the customer in a new and unique way. Then we will be competing on the basis of service, not just price.

The demand for consumer convenience is also having a major effect in our industry. Look at the growing amount of shelf space now devoted to value added and ready-to-eat products. As technology improves, we will see a shift to products that are more easily consumed.

The globalisation of the industry is also influencing the way we do business. We are global traders, exporting about [ ] percent of what we produce. Our markets will continue to shift as new competition develops at home and abroad, particularly in our Asian markets. We must be prepared to respond.

To compete in this fast changing marketplace, we must reform ourselves. We must reform to earn and to keep our market share. We need to shift from being a supply-driven organisation to becoming a customer-driven organisation. By focusing on the customer, we will find new ways to compete.

To position our business as a market-driven organisation, it is necessary to implement some internal reforms. We must change how we do business as a cooperative and redesign our marketing organisation to better fit today's marketplace."

Who said it? Yes, it could easily have been Sir Dryden Spring in the early 90s, or McKinseys advising Fonterra, but no – it was in fact the CEO of Sunkist, a large producer co-operative in the USA, in 2001.

The key issues facing the NZ dairy industry are common to large exporting producer co-operatives around the world. According to the US National Council of Farmer Cooperatives:

"The dramatic pace of change in the food, natural fibre and agriculture system is forcing a complete reassessment of the strategies needed for farmer cooperatives to continue to serve the farmer member," says Terry Barr, chief economist for the

National Council of Farmer Cooperatives. "Every segment of the business — from input manufacturing to production agriculture to food processing and marketing to food retailing — has undergone a transformation in the past decade. How cooperatives finance their future growth amidst such change is but the first of many questions."

Today, the cooperative industry is entering a new "new generation." Co-op boards and management move forward without a roadmap. Do they continue to work within the confines of a narrowly-defined cooperative structure that links local control and local capitalization? Or must they turn to outside sources to finance future growth?

Co-ops will shrink in number, increase in size, and become better at adapting to the fast-changing business environment, NCFC's Barr predicts. "Cooperatives can't just build a business on debt. They're going to have to get equity investment, if not from grower-owners then through preferred securities or stocks. It remains to be seen how cooperative principles will transfer onto a balance sheet of publicly-held subsidiaries that are wholly owned by farmer cooperatives." [*"Co-operatives at the Cross Roads: Expanding the Search for Capital"*, May 2002, Robert Heuer]

Producer co-operatives seem to work reasonably well while the products they make are very similar or closely related to the goods farmers supply. However, when the manufactured products become highly differentiated, the co-operative structure struggles.

Put simply, the mechanisms a business needs to be highly responsive to changing consumer demands do not sit comfortably with traditional co-operative principles.

As new Fonterra chairman, Henry van der Heyden's hardest and more important challenge is to help dairy farmers understand this reality.

Conclusion

While it is positive that Fonterra has finally adopted a strategy of some sort, the strategy is vague and general. It also fails to address the underlying problem of how a traditional closed producer co-operative can operate successfully in consumer-driven value-added markets.

Tony Baldwin
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COMPARISON OF FONTERRA's 2002 STRATEGY WITH THE INDUSTRY's 1999 STRATEGY

2002 STRATEGY	1999 STRATEGY	DIFFERENCES
5-10 year vision	5-10 year vision	*No change*
Achieve at least 13-15% total shareholder returns	Achieve 15% return on total gross assets	*2002 target is lower*
Strong co-operative principles underpin the strategy.	*Not as explicit*	*More emphasis in 2002*
'Theme 1": Be the lowest cost supplier of commodity dairy products	**'Horizon 1': Be the lowest cost supplier of commodity dairy products**	*No change*
Protect and promote the advantage we have to produce and market commodity dairy products at the lowest cost.	Defend and extend our position as the world's lowest cost producer of basic dairy products. This is our top priority	*No change*
There are real threats to our low cost position. We have to defend it aggressively	We risk losing our low cost advantage.	*No change*
Details not provided	Unit cash costs in NZ rising at 2.3% pa. USA unit cash costs falling at 1.8% pa. Average international decrease in unit cash costs is 2.7% pa	*No change in international trend*
Achieve on-farm productivity gains of at least 3-4% pa	Pursue aggressively on-farm productivity enhancements, including on-farm biotech	*Same, but 2002 adopts a specific 3-4% target*
Look at each step of the value chain and look at where improvements can be achieved	Adopt 4% real productivity target across entire value chain	*Similar, but 2002 drops the 1999 overall 4% target*
Ensure that growth in NZ milk is profitable. Farmers will need the right economic signals	Encourage profitable milk growth by sending right price signals	*No change*

2002 STRATEGY	1999 STRATEGY	DIFFERENCES
'Theme 2': Be the leading price and inventory manager in global commodity markets	Be a top trading and distribution company	*2002 language is new*
Be smarter in handling inventory, working capital, pricing and product mix	Send direct price signals to shift our product mix.	*2002 gives more emphasis to inventory management*
Continue to put the case at global and bilateral levels for trade liberalisation	Drive trade liberalisation. Capture the lion's share of the new value creation from trade liberalisation	*No change*
'Theme 3': Be a developer of dairy ingredient partnerships	**'Horizon 2': Leverage our ingredient network beyond NZ**	*2002 language is new*
Understand our customers better and create value for them	Forge closer alignment between manufacturers, the market and customers	*No change*
Bring to customers our technical skills to the table, not just dairy products	Sell technology skills, global trading network and risk management services	*No change*
'Theme 4': Be a leading specialty milk components innovator and solutions provider	**'Horizon 2': Build global 'slivers' in specialised ingredients.**	*No change in substance*
Create a pipeline of new specialty ingredients market	Dominate at least 10 specialised ingredient slivers	*Same, but 2002 drops the 1999 specific target*

2002 STRATEGY	1999 STRATEGY	DIFFERENCES
Build protein business	Focus on proteins – 93% of the top 22 speciality products are proteins	*No change*
Opportunities include protein hydrolysate products, colostrum market and pharmaceutical lactose	Most attractive products include protein hydrolysates, colostrum products and others	*No real change*
'Theme 5': Be a leader in consumer nutritional milks		*2002 language is new*
Build on Asian market, wanting milk with health and nutritional benefits	Focus and grow milks in consumer markets in SE Asia, including cultured drinks	*Similar*
Be on a par with the very best consumer companies in our speed to market	Benchmarked against top performing food companies	*Similar*
'Theme 6': Be a leading dairy marketer to foodservices in key markets		*2002 language is new*
Consumers want convenience – read to serve, off the shelf solutions		*More emphasis in 2002*
'Theme 7': Integrate strategies for China, South America, India and Eastern Europe	**'Horizon 2': Focus on Latin America and Asia – consolidate local markets in Latin America to grow milks position**	*Similar*
Fonterra will have flexibility to pursue other options, eg sourcing non-shareholder milk to support partnerships	Leverage our ingredients network beyond NZ dairy. Source non-NZ milk to capture growth opportunities	*Same, but 2002 links non-NZ milk to building partnerships*