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Fonterra's first year: Bad judgments, blurred boundaries

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The giant company trusted by dairy farmers to turn their milk into money has made a poor fist of its first year.

Signposts along the way included: a blow-out in corporate overheads; high salaries; 3,500 missed milk collections in a month; 100% excess working capital; too much money tied up in fixed assets; inventory levels too high for too long; $73 million spent on consultants' fees; lack of direction at the top, forcing the best commercial director to resign; and the export scandal of "Powdergate" still hovering in the shadows.

To cap it all off, Fonterra's main business, NZMP, earned just 3% before tax on shareholders' equity. Money in a bank on term deposit earned more.

Dairy leaders grossly over-promised what Fonterra could deliver. Expectations were unrealistic and disappointment was inevitable.

The "mega-merger" did not change things greatly from the Dairy Board regime. It integrated Kiwi and NZ Dairy Group 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 commodity milk price (CMP). And the Dairy Board did the spade work on the Nestl~ alliance.

What has changed is the quality of information farmer-shareholders receive. Thanks to the Shareholders' Council, they now get more performance analysis.

Many weaknesses identified in relation to Fonterra have in fact been buried in the system for many years - eg, tying up too much capital in stainless steel. The challenge for new chairman Henry van der Heyden is to free up some of that capital.

Fonterra can't readily hand back to the legacy companies the responsibility for employing the excess $1.5 billion of working capital. Nor can the problem of NZMP failing to cover Fonterra's CMP.

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

Whether a company or a co-operative, monopolies are by nature inefficient. Unless Fonterra believes that farmers will withdraw in large numbers, taking the full value of

their investment with them, it will be hard to keep Fonterra honest and efficient, year on year.

In 1999, McKinsey & Co issued leaders a stern warning about the risks of the mega-merger becoming inefficient. A "must" to counter this risk was that Fonterra should be required to deliver 4% real productivity gains every year, 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 withdrew its threat to walk away from the deal if any of its preconditions were not satisfied.

CEO Craig Norgate started his job saying Fonterra would achieve the CMP for suppliers. It now turns out that the gap between Fonterra's actual payout and the CMP is 39 cents/kg MS (or $430 million). Norgate now describes the CMP as an "aspiration."

Van der Heyden will need to enforce strong measures to close the $430 million gap.

Fonterra has set the "fair value" share price at $3.85. This figure is based on the earnings retained by Fonterra rather than what it pays out in the milk price.

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

In short, Fonterra has banked about $40 million of the $172 million savings assumed in the share price. Will it deliver the remaining $130 million or so? If not, farmers buying shares now at $3.85 could lose money.

The second problem is that non-tradeable shares are normally discounted by about 50% relative to shares that are fully tradeable. However, Fonterra allowed a discount of only 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 - ie, is vulnerable to arbitrary and questionable judgments by Fonterra.

Part of the problem is that the fair value mechanism actually has two roles. One role 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 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 $Kiwi but finished its first year in the "winter" of low prices and a high $Kiwi. While the industry's PR-machine at the time tried to have us believe milk was "white gold," Fonterra's summer was rather short.

- 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 to make money in the value-added area.

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

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

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

If they want Fonterra to guarantee the collection, processing and payout of all the milk they produce, no matter how much, and want it 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 shareholders 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.

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

I suspect the message from many of the directors would be that the co-op model has served the organisation well but that a new approach is needed to realise its full potential.

That's their belief but they won't say it. They're afraid of losing shareholders' confidence.

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

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