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"Tough cheese"

By Rebecca Macfie

Chris Welch has just spent 10 days reviewing the budget for his 700-cow dairy farm near Gore, in Southland. He's over his fuming anger at last month's news that the payout from dairy giant Fonterra will be just $3.60 per kilogram of milk solids — 10 cents less than the $3.70 farmers have been banking on since mid-way through last year. After all, he's well aware Fonterra is in a commodity business and these are the sorts of swings and roundabouts to be expected.

The dairy industry's golden summer of high payouts is over, and it won't be just Welch and his 13,000 fellow Fonterra farmer shareholders who feel it: the dairy industry accounts for some 7% of New Zealand's GDP, and Fonterra pulls in 20% of our export earnings. This year's $3.60 payout is 32% less than last season's $5.33, and amounts to $1.9 billion less going into farmers' bank accounts. Suppliers, retailers, real estate agents and other businesses in provincial towns and cities that enjoyed the effects of high payouts in 2001 ($5.01) and 2002 will very quickly feel the chill.

If a 10-cent drop in payout doesn't seem like a big deal, think again. Despite the bravado and hype surrounding the industry during its recent expansionary phase, dairying is basically a low-margin business. Even before the payout was revised downwards from $3.70, Ministry of Agriculture and Forestry figures showed that the average dairy farm would produce a small cash deficit this season after all costs, including interest, tax and capital development, were paid.

MAF predicts farmers will cut their cloth by putting a cap on capital spending, slashing repairs and maintenance costs, and, in some cases, by suspending principal repayments to the bank. Some will be forced to take on further borrowings to tide them over, and the bulk will use off-farm income to help them ride through.

Welch predicts that after reworking his budget, he'll end up with a small cash surplus before tax. "But it really just means there won't be enough money to do everything," he says. Two seasons of relatively high prices have meant farmers have tended to opt for the "Rolls Royce version" of everything, and this year cheaper alternatives will have to be found. For instance, last year Welch was able to use copper capsules as a means of getting minerals into his cows, at a total cost of around $4000–$5000. This year he'll go for a copper injection, which is harder to do, tougher on the animal and may not get quite the same result, but can be done at a fraction of the cost.

Kevin Wooding, chairman of Dairy Farmers of New Zealand, says on-farm operating costs have gone up by 20% since 1999. And there's little elasticity in many of those costs: farm salaries, which tracked up in response to the demand for skilled workers on the big new conversions, can't just be cut back overnight. On farms of the scale of Welch's, the traditional option of sacking the workers and putting the missus and kids back in the milking shed is not available.

Wooding, who farms in the Waikato, says farmers are survivors and well practised at riding out price fluctuations. But he says those most exposed are farmers who have just converted properties to dairying (76 farms were converted this season) or expanded by buying another farm. "If they get a bad payout in their first year they may have to go back to the bank for more finance," he says.

The effect of dry conditions in many traditional dairy areas such as the Waikato and Taranaki will add to the pain. Wooding expects milk production on his farm to be down 10% this season.

But short-term survival is one thing; long-term sustainability is another. Many banks have assumed a payout of $4 or more when financing recent dairy conversions and purc hases. Westpac is among the more cautious, with an assumption of $3.90, while the National Bank has operated within a range of $3.80 and $4.25. These figures signify the long-term payout levels that the banks believe are necessary for a farm to pay its way (including principal repayments), plus generate a decent return on capital.

All the banks Unlimited spoke to say they are not worried about this year's price trough and that they're not about to start foreclosing on their dairy clients. Still, it's clear that the industry can't afford to linger at payouts below $4 for long before banks start feeling twitchy about the $17 billion they have tied up in farm debt.

Current predictions are that prices will head back towards $4, but not in the near future. Commodity prices have lifted off last year's lows, but Fonterra is still only picking a payout of $3.70 to $3.90 next season.

All in all, it's another salutary reminder the New Zealand dairy industry and its corporate embodiment, Fonterra, remains a commodity business at the whim of global price cycles. In real terms, dairy prices have been heading down for decades, and this year's price is simply a reversion to the levels seen throughout the 1990s. Looked at in this historical context, the $5-plus payouts of the previous two seasons are an aberration. Farmers have mitigated this historical trend by producing more milk per cow, carrrying more cows per hectare, and driving for economies of scale by running bigger herds.

The real question for Fonterra's shareholders as they contemplate a $3.60 final payout is, despite the collapse of commodity prices last year, could the company have done better? Wooding thinks so; he wants to know when the promised benefits of the dairy megamerger will finally start to flow through to farmers.

One of his concerns is that the company sold down its inventories — stockpiled over four years — at the bottom of the price cycle, much of it at below book value. "Did Fonterra cause commodity prices to go down? Why sell at the bottom of the market?" he asks.

Fonterra chairman Henry van der Heyden is aware some farmers share Wooding's interpretation, but he says it's wrong. For as long as the company sat on big stockpiles, international prices weren't going to recover. The existence of the stockpile, rather than the decision to sell it, was what was depressing prices, he says. By emptying the stores, the company has been able to lead prices back up.

And he reckons the efficiencies promised when Fonterra was formed are already benefiting farmers, despite the lower payout. "There's no doubt in my mind that if we hadn't formed Fonterra the farmers would be receiving less than they are receiving now." Merger benefits amounted to $116 million at the November 2002 half year, and van der Heyden says this translates to an extra 10 cents a kilo to farmers' payouts. By the end of the season he expects that to be 15 cents.

Which is all very well, but Fonterra is still badly underperforming the two independent dairy co-ops. Westland is promising its shareholders $3.90 this year, and Tatua, which specialises in value-added ingredients and consumer goods, is promising at least $5.

But underlying all of this is a deeper frustration to do with Fonterra's capacity to reduce its exposure to the commodity price roller coaster and deliver real wealth to farmers and an expectant nation. Welch says if Fonterra wants to move into high-value, niche products, it's going to need fresh capital. And at payouts like $3.60, there's no way its farmer shareholders will be able to provide it.

"Where is the capital going to come from to become a global player in the high-value ingredients market? The returns are out there in those markets, but the sheer capital cost of getting into those markets are really outside the realms of the cooperative structure."

If the industry fails to address this issue, says Welch, Fonterra will never be anything more than a low-cost commodity trader.

"Crikey, I'm going to be lynched for this," he laughs. It might be a joke, but it speaks volumes for the readiness of Fonterra's 13,000 shareholders to face up to the inherent weakness of the megamonopoly that promised so much and has so far delivered so little.

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