THE PRESS

26 APRIL 2003, Edition 2, Page 6.

Crunch time looms for Fonterra leadership

By TONY BALDWIN

Accountability in large companies tends to be fickle. Directors love to bask in good-news glory but when things turn sour most dive for cover. Too often only the chief executive is left standing in the line of fire.

In its first two years, Fonterra's performance has not been strong -- certainly well below expectation.

All eyes are now fixed on whether the chief executive officer (CEO), Craig Norgate, will keep his job.

But accountability rests with the board, not the CEO. The board sets goals and priorities for its CEO. If the CEO achieves those targets yet the company still performs poorly, the board is responsible, not the CEO. The board's strategic vision is likely to be weak.

If, on the other hand, the board sets the right goals but the CEO failed to achieve them, the CEO is responsible.

These questions are now sharply in focus at Fonterra, New Zealand's largest company. Within six weeks, decisions will be made on its CEO and three directors.

During its first two years, Fonterra's governance and management has been weakened by three key problems. The company inherited a divided board, the board `inherited' its CEO, and the CEO inherited two of his key senior managers.

Each original appointment was made in the grand political compromise between Kiwi, Dairy Group, and the Dairy Board when forming Fonterra.

Regrettably, Fonterra has lost nearly two years waiting for these weaknesses to be remedied.

An announcement is expected shortly on Fonterra's CEO.

Of equal importance will be shareholders' decision on whether to return three directors.

Eleven candidates are vying for the three board positions. An election campaign road-show starts in Whangarei on May 7 and ends a week later in Ashburton. Voting packs and a video of each candidate are to be sent to all 14,000 Fonterra suppliers and votes will be cast under the system of single transferable voting (STV).

The key issue for voters is how to grow the business and increase profitability.

Fonterra has a comparatively weak balance sheet. Shareholders own just 26% of its assets. Growth cannot be funded from debt alone. More share capital will be required but where will it come from?

This raises the thorny question of non-farmer investors -- an issue confronting producer co-ops around the world.

Many different solutions have been developed.

Many Fonterra farmers want to believe that the 2001 mega-merger relieved them of this problem.

Not so. In the international dairy foods business, Fonterra is neither large nor small. It is not a specialised boutique player (like Tatua), nor is it a powerful foods maker (like Nestle, Kraft, and Unilever).

Even in its area of traditional strength -- basic dairy commodities (butter, cheese and powders) -- Fonterra is not particularly efficient (as shown by the gap between the `commodity milk price' and its `actual milk payout'). In short, Fonterra is in no man's land.

Key questions for aspiring directors are: what should Fonterra be and how will it get there; will it confine itself to New Zealand milk or process more milk overseas; will it diversify into non-dairy; if not, how will it lift its payout? The company's strategy that was released in August 2002 is simply too vague, too general, and tries to be all things to all people.

Here are four related but more specific issues Fonterra must address.

Transparency

Fonterra must be more transparent and cut down on hype. Fonterra is better at spin than most political parties. As an example, the company trumpets its joint ventures in India, Britain, the United States, and with Nestle as major breakthroughs likely to boost returns to farmers significantly. Yet, in its own calculation, the joint ventures represent just 3% of Fonterra's future value streams. But Fonterra still refuses to provide meaningful information to suppliers on the joint ventures' expected capital requirements and arrangements for sharing risks and rewards.

Prices on the farm

Pricing to farmers has been a fundamental problem in the industry for many years. Put simply, Fonterra and its predecessor co-ops have not paid farmers the true economic value of their milk. True value varies across seasons, regions, and volumes. The traditional payout also `bundles' together returns from quite different activities. This has caused lots of distorted investment decisions. Unbundling the farmers' payout and paying the true marginal value of raw milk is absolutely fundamental if Fonterra is to succeed. It also happens to be politically hard as it will unravel lots of hidden cross-subsidies among farmers. However, if Fonterra fails to do it, its future is not promising.

Valuing shares

Monitoring and share valuation is another key issue. Every major decision by any company has an impact on its value. For large listed companies, these impacts are assessed on an on-going basis by lots of different institutions and reflected in the company's changing share price. By contrast, Fonterra's value is only assessed once a year by one firm following an administered process.

In addition, Fonterra's share regime is confused by trying to achieve in one instrument four different objectives. Fonterra's `fair value share' is designed to reduce the flow of new milk, reduce wealth transfers from existing to new suppliers, reduce barriers to suppliers switching from Fonterra to a competitor, and provide an indication of Fonterra's expected future earnings.

Clearly, some of these objectives conflict with each other. Others create new risks for Fonterra, like the impact of many suppliers redeeming their shares at the same time. In short, Fonterra's `fair value share' achieves none of these objectives particularly well. It has also created complexities that few directors understand. Simpler, better mechanisms are available.

Leadership

In an industry created by the Government, it is not surprising that its leaders have tended to act like politicians. They get elected by reflecting what most suppliers think and like. Many say Fonterra's current chairman, Henry Van Der Heyden, is waiting to get a stronger majority of like-minded directors on his board before addressing the key issues outlined above. If this is true, it is a great shame.

For too long the industry has been held back by weak leadership. Few directors have understood the real issues. Too few of those have had the courage to say and do what they know to be right. Suppliers want to be led. But real leadership means reaching beyond the industry's age-old prejudices that seriously limit its potential.

Fonterra's director election process should not be a popularity contest. It should not reward candidates whose views square comfortably with the majority of suppliers. Rather, it should select people with strong strategic and analytical skills, an ability to think independently, an objective understanding of Fonterra's strengths and weaknesses, an ability to make hard decisions, and, most importantly, the strength to lead change with suppliers.

Tony Baldwin, a dairy analyst based at Motueka, led the Producer Board Project Team in 1999 and was a policy adviser to the Department of the Prime Minister and Cabinet from 1991 to 1998. He was one of the few people who questioned the merits and structure of the merger process which led to Fonterra.

CAPTION:

Waiting for change: long-standing prejudices are limiting the potential of the dairy industry.

ELECTION ROADSHOW

North Island

Whangarei, 7 May at Forum North, starting 10.30am

Pukekohe, 7 May at Field Function Centre, starting 7.30pm

Te Awamutu, 8 May at Presbyterian Church, starting 10.30am

Matamata, 8 May at Memorial Centre, starting 7.30pm

Rotorua, 9 May at Quality Hotel, starting 10.30am

Edgecombe, 9 May at Edgecombe Hall, starting 7.30pm

P/North, 12 May at Hotel Carlton, starting 10.30am

Stratford, 12 May at Multisports Centre, starting 7.30pm

South Island

Invercargill, 13 May at Working Mens' Club, starting 10.30am

Balclutha, 13 May at South Otago Town & Country, starting 7.30pm

Ashburton, 14 May at Ashburton Hotel, starting 10.30am

Part: C
Section: BUSINESS
Column: BUSINESS DAY
Topics: DAIRY INDUSTRY ; MANAGEMENT ; ELECTIONS
Corporate: FONTERRA