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Brian Gaynor: Fonterra facing scary questions

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COMMENT Fonterra's $1.5 billion offer for National Foods is scary. It is frightening because Fonterra doesn't have the appropriate structure for an aggressive overseas expansion strategy, the acquisition will be 100 per cent debt-funded and the dairy giant's hostile tactics are inappropriate.

The problem with Fonterra is that it is a co-operative, which gives it a limited ability to raise new equity.

Shares are issued to suppliers on the basis of milk supply and most of the group's earnings are distributed to supplier shareholders, although it does have the ability to issue capital notes to non-farmers.

As at May 31, Fonterra had retained earnings of only $74 million, equity of $4.8 billion and total assets of $11.1 billion.

Most co-operatives put a strong emphasis on cutting costs and operating efficiencies, because their growth potential is restricted because of capital constraints.

One of the ways around this capital constraint is to invest in off-balance sheet joint ventures. Fonterra has adopted this strategy, but it is risky because control is diminished and many joint ventures fail because of blurred governance structures.

Listed companies have far more flexibility and they usually issue new equity when they make overseas acquisitions.

Fonterra's acquisition of National Foods will be wholly debt-funded and this will weaken its balance sheet. This is a risky approach, particularly as it is paying top dollar.

The group needs to look at alternative strategies, particularly those adopted by a number of Irish dairy co-operatives.

In the early 1980s, Ireland had six big dairy co-operatives. Kerry Co-operative Creameries, based in the poorer southwest of the country, was the smallest. The country's dairy industry was faced with declining milk volumes, because of EU quotas and a reliance on commodity markets.

The co-operatives had two alternatives; they could cut costs, or expand and diversify through acquisition.

Kerry, which had a young and aggressive management team, opted for the latter.

When the Kerry board adopted the new internationally oriented expansion strategy, it realised that capital would be required and this could not be delivered under the traditional co-operative structure.

According to James Kennelly in The Kerry Way, The History of Kerry Group, 1972-2000, the co-operative's management undertook an extensive investigation of funding options and came to the conclusion that a partial sharemarket float was the only practical alternative.

But Kerry farmers are a suspicious lot and have a strong sense of nationalism. They didn't want to lose control of their co-operative and had little time for the moneymen from Dublin.

Kennelly says the idea of control went well beyond the bland definitions of financial control or mere majority ownership. It was deeply heartfelt, emotional, philosophical and inextricably tied to the history of the organisation.

Nevertheless, the Kerry board was convinced that the organisation had no option but to grow and, if this was financed through borrowings, then control would be lost to lenders.

It would be better to have a strong company with some outside shareholders than a 100 per cent farmer-owned co-operative that was up to its neck in debt.

The determination of the board and management finally overcame the objections of farmers and on December 9, 1985, Kerry Co-Operative shareholders voted for the issue of new shares to outsiders.

The restructuring was achieved as follows:

* Kerry Group was formed and acquired the assets of Kerry Co-operative through the issue of 72 million Kerry Group shares. Kerry Co-operative became a holding company with no operational connection to the Kerry Group.

* Kerry Co-operative shareholders were issued 10.3 million Kerry Group shares at 35p each.

* Institutions and the public were issued eight million shares at 52p each.

After the restructuring, Kerry Co-operative owned 80 per cent of Kerry Group, farmer shareholders another 11 per cent in their own name and the investing public 9 per cent.

The issue of shares to farmers at a discount was a big risk because they could have immediately dumped them for a quick profit. But the farmer issue was oversubscribed and few sold their shares on listing.

The conversion of Kerry to a listed company has been a huge success. Within a short period, three of the country's remaining five dairy co-ops were restructured into listed companies and farmers now had four topics of conversation: milk prices, the weather, the Kerry football team and Kerry Group's share price.

Its share price of around €17.97 gives it a total sharemarket value of €3.34 billion ($6.2 billion). The company has had an aggressive international expansion strategy, partially financed by the issue of new equity, and only 26 per cent of sales and 22 per cent of operating profit are now generated in its home county.

Kerry Co-operative's shareholding has been diluted from 80 per cent to 31 per cent with almost no opposition from farmers.

This 31 per cent holding is now worth €1.04 billion, whereas the original 80 per cent stake has been valued at the equivalent today of €48 million in 1986.

The Irish dairy industry has come a long way. A photograph in Kennelly's book shows Kerry farmers queuing outside a creamery in 1960 with small two-wheeled carts pulled by donkeys. A photograph in the 1999 New Zealand Dairy Board annual report shows our farmers were motorised in 1928.

Fonterra's aggressive tactics also indicate that the organisation would benefit from the disciplines imposed, and experience gained, from a sharemarket listing.

Fonterra has had a 17 per cent shareholding in National Foods for several years without board representation.

At the start of last month, the Australian company said it was having discussions with SPC Ardmona regarding a possible merger. This obviously upset Fonterra because, 17 days later, it made a $5.45 a share cash offer that was conditional on National Foods not announcing or proceeding with any merger or similar arrangement with SPC Ardmona.

The hostile bid was a high-risk strategy because it represented a premium of only 16.7 per cent to the previous day's closing price and Australians take a very nationalistic view of their companies.

Why didn't Fonterra try to negotiate a deal with National Foods?

Surely it knew that a hostile bid would meet strong opposition and would be difficult to win unless the premium was closer to 25 per cent.

National Foods would be a good fit for Fonterra, but it looks as if it will have to offer up to $5.85, a 25 per cent premium to the pre-bid price, if it is to be successful.

This would value the Australian company at A$1.74 billion or 22 times the forecast June 2005 year earnings.

This is a top price to pay, particularly when the purchase will be totally debt-funded.

It demonstrates that an aggressive international acquisition strategy is incompatible with a traditional co-operative structure.

How long will it take before New Zealand dairy farmers adopt a more practical and realistic corporate formation?

Irish dairy farmers embraced the modern corporate structure nearly 20 years ago. Isn't it time we followed suit?

* Disclosure of interest: Brian Gaynor is an executive director of Milford Asset Management.