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Richard Inder: **Fonterra goes through hoops**

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HOOPLA

Fonterra is putting itself through the hoops to avoid a sharemarket listing of its money-hungry consumer products arm, NZ Milk. But for the moment, at least, this is no bad thing.

The latest plan is to:

* Offer contracts to supply milk without requiring farmers to buy shares in the co-operative in proportion to the amount they supply.

* Give separate balance sheets to its two divisions - Fonterra Ingredients (commodities) and NZ Milk (consumer products).

The plan is aimed at resolving what Fonterra euphemistically calls "tensions" that in the long term could threaten the co-operative.

The first of these tensions is that farmers do not have a clear idea how their huge investments off-farm are performing. This makes it difficult for Fonterra to convince farmers to fund growth, particularly the growth of NZ Milk.

Fonterra makes an annual payout in proportion to milk solids. It separates this into a commodity component and a value-add component. Both figures are artificially determined by the number-crunchers and their consultants at head office.

Meanwhile, the value-add component of the payout does not distinguish between the contribution from the commodity business and the consumer products business.

Fonterra's highly valued shares could also deter new people from joining the industry and encourage share redemptions.

These are, again, forces that could deprive the co-operative of the capital it needs to grow.

It hopes contracts for milk will lower barriers to entry into the industry and give those reluctant to increase their off-farm investments an alternative. It also gives the number-crunchers a better idea about the value of the commodity milk price, because they will be able to refer to real world negotiations.

Separate balance sheets for the NZ Milk and Fonterra Ingredients would improve signals at the farm gate. A reported net profit figure for each division would allow the co-operative to more clearly set out how much value the divisions are adding to the commodity price.

The proposals are small steps and still suffer from the problems they are designed to resolve.

The raw milk component of the payout will still be determined by the number-crunchers, even though they can refer to a real market.

As Fonterra would be the dominant buyer of milk, it will be setting milk prices. And as contract milk will not be accompanied by an injection of equity, it also puts pressure on Fonterra's balance sheet.

Giving each side of the business separate balance sheets only makes public what the co-operative's financial reporting systems already provide.

The move improves transparency but is, in itself, not a huge transformation. Ultimately, a listing may be the only way to resolve these problems. Fonterra's recent success and size would ensure its every move would be closely scrutinised by an army of financial analysts and, as a result, success - or lack of it - would be immediately transparent in the movement of its share price.

And even if management is workman-like, sharemarkets are still likely to come up with the cash. But that is not enough to push ahead with such a move.

Fonterra is refreshingly candid in its view that NZ Milk is not performing. A share sale before these unknowns are resolved could deprive shareholders of sizeable returns.

Fonterra has taken steps to solve the problems. It has employed brand expert Sanjay Khosla, who revitalised Unilever's Lipton Tea brand, to lead the division.

In the meantime, its $1.5 billion bid for Australia's National Foods has the potential to make NZ Milk a force to be reckoned with.

Finally, NZ Milk's success combined with this latest wheeze may yet be enough to solve the shortcomings of the co-operative structure and retain benefits, such as keeping the bulk of the group's profits here.

RURAL MOVES

The dairy giant's alliance with Pyne Gould Guinness yesterday to make a bid for a cornerstone stake in rural services group Williams & Kettle shows its determination to deliver.

The play is a first step to consolidation of the rural services sector. The end game from this first step is closer links between Pyne Gould Guinness, Fonterra's RD1 and Williams & Kettle.

Fonterra had eyed a similar goal when it took a cornerstone stake in Wrightson. That bid was thwarted when the co-operative's former chief executive, Craig Norgate, and the McConnon family made their partial takeover of the group.

Wrightson has predictably entered the fray. This bidding war and Fonterra's bid for National Foods is set to keep the markets entertained in the lead-up to Christmas.