Which Way Fonterra?

By Phil Barry, Economic Consultant

Over the last twelve months several New Zealand agribusinesses have made cautious first steps into external capital markets. For example, the last year has seen:

- Livestock Improvement Corporation, the knowledge-based dairy co-op, become the first farmer-owned co-operative to list on the New Zealand stock exchange (the alternative exchange, NZAX);
- Wool Equities, an offspring of the old Wool Board, also listing on the NZAX; and
- Open Country, a start-up dairy processor and exporter, raising $20 million through private equity markets.

Later this year, the country's largest kiwfruit processing co-operative, Satara, is also expected to list on the NZAX.

At the same time, there have been some moves in the other direction. In particular, formerly listed meat company, Richmond, is now a subsidiary of the South Island-based co-operative PPCS.

In the case of Fonterra, New Zealand's largest agribusiness and largest company overall, an active debate is going on about its future capital structure.

Fonterra has already taken steps in recent years away from the traditional co-operative 'dollar in, dollar out' model (under the classic co-operative share structure, the value of the shares doesn't alter over time – a shareholder with a $1 share will only get $1 for that share when he/she leaves the co-operative). The move to fair value entry and exit for Fonterra's standard shares, the establishment of Peak Notes and the setting of an independently assessed Commodity Milk Price were all significant steps in opening the company to greater external market disciplines.

Now the appropriate capital structure for the company is being investigated. Currently only dairy farmers are able to hold shares in Fonterra and voting rights in the company are tied to each farmer's level of production. That ensures farmers can control the company. But such control comes at a cost. The costs include reduced opportunities for farmers to diversify their assets and the inability of farmers to get full value for their shares.

The debate, however, is about more than just capital structure *per se*. Underlying the capital structure debate are issues of corporate culture and strategic direction. A co-operative company is a business primarily concerned with providing services to its shareholders. As Fonterra proceeds down the path of more value-added products, new opportunities will arise that need more capital and that do not necessarily suit the risk and liquidity preferences of all its current shareholders. Currently Fonterra's consumer branded business, NZ Milk, is losing ground, with annual revenue down

6% and operating profit down 28%. Dairy farmers with sizable debts on their own balance sheets may well be asking themselves why they should have to keep pouring money into such risky ventures.

Likewise, some farmers are questioning whether there are other, potentially less costly, ways of obtaining the security provided by the co-operative model. Long-term contracts with a common stock company are one option. Dairy farmers in Australia and other countries enter long-term contracts with investor-owned corporates that seem to serve the producers' and processors' interests well. Another option would be for the co-operative structure to remain for Fonterra's core milk collection and processing business, with value-added activities spun off into an entity that has access to outside capital.

Co-operative vs Common Stock

Co-operative	Common Stock Company
◊ Control	◊ Diversification
◊ Exposure to downstream businesses	◊ Value uplift
◊ Monitoring by farmers	◊ Transparency
	◊ Access to capital

There are advantages and disadvantages for Fonterra's supplier-shareholders in maintaining the traditional co-operative structure. The advantages of the co-operative structure can include:

– **control** by dairy farmers, thus ensuring the company remains focused on their interests, including, most importantly, picking up the milk they produce each day;

– **exposure to downstream activities**, allowing farmers a stake in and control of some activities between the farm and the customer ('cutting out the middleman'); and

– **monitoring** of the directors and management by stakeholders who are close to the business: for example, Fonterra has its 'Farmer Community Network', with a ratio of one network member for every 20 shareholders

On the other hand, the advantages of permitting some degree of external capital could include:

– **diversification** by farmers of their off-farm investments, with less risk as a result. Currently the average dairy farmer is doubly exposed to the fortunes of the dairy industry – as well as having a substantial investment in the farm, the average farmer has close to a further half a million dollars invested in Fonterra. Capital restructuring could allow farmers themselves to decide how and where to invest their off-farm assets;

– **a value uplift** due to the free tradability of shares. An indication of the typical uplift can be obtained from a study by the American Securities and Exchange Commission. Looking at 398 publicly traded companies, the study found the average discount on trades of restricted shares was between 26% and 33%. Even if the discount on Fonterra's shares was only half that (ie around 15%), each of its 13,000 farmer-shareholders would currently be forgoing around $65,000 on average;

– **greater transparency** through the monitoring done by a variety of external analysts and through the benchmark provided by a market-determined, rather than an administered, share price; and

– **better access to capital** to fund growth opportunities. As Nestlé's CEO Peter Brabeck notes, "when you stop growing you start dying". Some of Fonterra's directors are said to have estimated the company will need to find about $4 billion from sources other than dairy farmers to help fund expansions during the next decade.

The choice between investor-owned corporate and co-operative need not be a black and white one. There is, in fact, a whole range of organisational forms with different attributes of these two models. So-called hybrid co-operatives are becoming increasingly common in the dairy industry. For example, in Australia shareholders in one of the largest dairy co-operatives, Dairy Farmers, voted in June this year in favour of restructuring the co-operative into two parts – a 100% supplier-owned co-operative which will purchase its members' milk and a separate 'value added' co-operative (20% owned by the supply co-op and 80% owned by members directly) which will process and market the milk. The supply co-operative will focus solely on the interests of members as suppliers of milk. The 'value-added' co-operative will seek to maximise profits from the processing and marketing of the milk. The next stage of the restructuring, yet to be approved, is planned to involve the corporatisation of the value added business, so that external equity can be raised through a listing on the Australian stock exchange.

Another example is Australia's fifth largest dairy processor, Warrnambool Cheese and Butter's. Earlier this year the company's supplier shareholders voted in favour of introducing non-farmer shareholders through a listing on the Australian stock exchange. The listing was successful, with shares achieving a 20% premium on the first day of trading.

Kerry Dairy of Ireland is a further oft-cited example of successful restructuring in the dairy industry. In 1986, Kerry's supplier-farmers owned 100% of the company, a company valued at 45m Irish punts. The farmers decided to list the company on the stock exchange while retaining 52% through a co-operative structure. By 1996, Kerry was a successful multi-product multinational business worth 1,100m Irish punts, and was still 52% owned and controlled by the farmer co-operative. Subsequently, the farmers (whose investment had increased in value over tenfold) decided, by a 75% vote, to sell down below a 50% shareholding.

Co-operatives and investor-owned firms each have different merits. In a healthy dynamic economy, a variety of organisational forms will exist and evolve and be allowed to compete on an equal footing. The questions for New Zealand's dairy farmers are whether the advantages of the current restrictions on ownership in

Fonterra still outweigh the costs and, if not, which ownership structure is likely to be in the best interests of Fonterra and its farmer shareholders in the future.

Phil Barry is a principal of corporate finance advisors Taylor Duignan Barry Ltd (www.tdb.co.nz).