TARANAKI DAILY NEWS

FONTERRA:

REPLY TO GRAHAM STUART'S ARTICLE

Published in Taranaki Daily News on 28 October 2004

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Key issue

Co-ops come in all shapes and sizes. Some have consumers as members. Suppliers are the shareholders in others. Some have outside investors, others don't.

The debate about Fonterra is not whether co-operatives in general are good or bad.

As eminent economist, Paul Samuelson, pointed out, cooperatives are not anomalies, but competitive institutions that form an integral part of a healthy market economy.

The Fonterra debate centres on how a supplier-only dairy cooperative can realise its full potential, particularly in its downstream businesses, for the benefit of shareholders.

Dairy co-op limits

Traditional supplier co-ops tend to work best when capital demands are relatively low, the product supplied is very similar to the product manufactured, and suppliers share the same goals and appetite for risk.

Co-ops in many countries have also relied on special government treatment, including exemptions from anti-monopoly laws, tax concessions and other special deals.

The NZ dairy industry has been in this category for nearly 100 years.

Change any of these factors and closed supplier co-ops can start to face difficulties. Form no longer fits function.

The tensions become particularly acute when they try to move into higher margin consumer markets.

These themes resonate in commentaries across the co-operative world. This is not an ideological beat up on co-ops.

Many traditional supplier co-ops have therefore changed their capital structure. A range of hybrids have been developed.

Fonterra's situation

Fonterra has made some useful cost-savings since the 2001 merger[1].

However, its commodities strategy is short term and still based on the notion of managing international prices.

Significant growth in downstream activities is also likely to be problematic.

Despite PR hype to the contrary, the industry's track record in new consumer-end products has been poor. Many of the Dairy Board's initiatives were not profitable.

A risk-adjusted downstream strategy is therefore is essential. Within a few years, however, capital is likely to become a problem if full potential is to be unlocked.

As CEO Andrew Ferrier hinted earlier this year, "while Fonterra can fund the immediate needs of the cornerstone activities and current options within our existing balance sheet, as the business evolves this may not always be the case".

Approach to capital structure review

In most businesses, structure follows strategy. In Fonterra, it is the opposite. This is its main Achilles Heel.

[1] 1999 analysis indicated that nearly half of the $300m savings would come from gains not related to the mega merger

Industry politics precludes an intellectually open and objective discussion of structural options that may better achieve key goals – for the benefit of existing shareholders and the NZ economy.

I am not the only person to propose a normal company structure with outside capital for Fonterra's downstream businesses. Dr Zwanenberg of Rabobank, one of the world's leading dairy co-op advocates, has recommended a similar structure[2].

Friesland Coberco, a large dairy co-op in the Netherlands, now has a separate tradable 'B' share, similar to NZ's Livestock Improvement Corporation. Supplier-shareholders receive dividends separately from milk payments.

It is unfortunate for suppliers that the public part of Fonterra's capital structure review excludes these options.

Measures of success

Contrary to Graham Stuart's claims, the measure of Fonterra's success is not how much capital is invested, or the rate of increase in milk production.

The criterion that counts is the rate of return generated on shareholders' funds after covering full costs.

On this score, performance for the average dairy farmer is not so strong. Net profits return only 2-4% on assets. This has been the pattern for many years. Dairy farmers have relied on rising land prices to cover their cost of capital[3].

The industry has certainly done well in cultivating its image as a huge success story. Closer analysis of the long term opportunity costs would suggest otherwise[4].

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[2] See Catherine Bull's 1999 Nuffield Scholarship Report, "Retaining Co-operative Characteristics Amid Globalisation", at page 35

[3] It is unclear that profit fundamentals support some of these land value increases (not related to alterative land use opportunities)

[4] The same capital invested in Nestle shares 30 years ago would have created significantly more wealth than dairy farming

Managing milk volumes

For many years, dairy leaders have lamented the ever growing 'wall of milk', stressing that supply needs to be driven by consumer-demand, not suppliers' production-push.

Fonterra claims its administered share price will control milk volumes. This is a crude approach.

A Fonterra share signals expected future net profits after paying suppliers for milk. It does not signal the market value of raw milk, particularly if the non-commodity components of Fonterra's future net profits grow.

The proper way to manage milk flow is to show suppliers the market value of producing an extra unit of milk. These price signals are needed within the season and beyond.

Fonterra also needs to contract for the volumes of milk it wants to meet customer demands. Making contracts tradable among suppliers would further improve the quality of price signals.

Property rights

Graham Stuart claims that parcelling Fonterra's downstream business into a normal company would ride rough shod over shareholders' property rights. This is quite wrong.

Any change of this kind would require a constitutional vote of Fonterra's members. More importantly, shareholders could continue to own and control the company.

Culture

Fonterra is NZ's largest company by some margin. Yet it faces extremely limited outside scrutiny[5].

[5] This is the only reason I continue to comment on Fonterra

For 100 years, the industry has been used to controlling public information. Leaders continue to hide behind myths and slogans. PR advisers keep fuelling fears with misinformation. Dissent gets smothered.

None of this helps the company, its shareholders or the economy.

Fonterra's leaders need to be intellectually open and honest – to expose all the issues and options to suppliers.

It would also be helpful if Fonterra stopped using inappropriate labels in response to criticism.

Conclusion

Fonterra claims it can maximise both milk prices and net profits within its current structure. This is simply not possible.

As Prof Michael Jensen of Harvard University observed, the result of conflicting objectives is "confusion and a lack of purpose that handicaps the firm in its competition for survival".

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27 October 2004