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FONTERRA: A CONSUMER STRATEGY?*

By Tony Baldwin

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A key aim in Fonterra's strategy of taking over National Foods is to significantly grow its dairy consumer business. For many years, the performance of NZ Milk – Fonterra's consumer arm – has been poor. The pivotal questions are why, and will buying National Foods turn it around?

Fonterra is good at producing low margin, high volume commodity dairy products: milk powders, butter and simple cheese. Some is packaged and branded for sale to direct to consumers. Most is exported to other firms as a basic, low value ingredient.

Working in thin international dairy markets (only 7% of world production is traded), Fonterra's predecessor, the Dairy Board, was relatively successful in developing world-wide distribution and sales channels to off-load the 100% increase in NZ's milk production over the last decade.

* This is Tony's title for the article

However, with downward dairy prices, volatile exchange rates, and increasing costs of production (our farmers are no longer the world's cheapest milk producers), NZ's dairy commodities business has, in essence, been sprinting to stand still. Farm operating returns as a percentage of net assets have averaged 3% over the last 12 years. Contrary to years of clever PR, raw milk is not "white gold". Farmers' main wealth gains have come from rising land prices, which does not seem to be properly supported by profit fundamentals.

Fonterra's consumer arm, NZ Milk, was set up in the early 1990s by the Dairy Board to "develop high value branded or specialised products and take them into positions of market leadership". Commodity products – butter, cheese and milk powder – were repackaged and branded for sale direct to consumers. New products like mozzarella cheese and nutritional powders were also rolled out.

The Board's strategy was to "minimise our dependency on commodity sales and place the value-added products our industry makes so well in the market sectors offering the highest returns", explained ex-Board chief, Warren Larsen.

Once again, despite the PR hype, profits as a percentage of revenue were negative for each product category, except for powders.

In 2000, the strategy was re-framed to become the 'milks strategy'. "Our competitors have a full range of products – yogurt, pasteurised fresh milk, UHT, fresh cheese, dairy desserts and so on. If we are serious, and we are, then we must emulate them", emphasised ex-Board chairman, Graham Fraser.

Fonterra's joint ventures with Nestle, Dairy Farmers of America and Britannia are part of this strategy. So is buying National Foods. However, to succeed in growing a higher-margin consumer business, Fonterra will have to address five fundamental issues.

First, Fonterra should not be able to draw on suppliers' captured capital under its compulsory share purchase scheme. The directors should have to persuade their suppliers to subscribe capital on a voluntary basis for investment in overseas consumer businesses. Suppliers should also have the right to sell their shares in these investment activities if they are not happy, without having to cease their supply of milk to Fonterra. Only then can Fonterra claim it faces proper accountability and commercial disciplines.

Second, in the relatively near term, Fonterra will probably have to source more equity capital. Protecting and building brands is extremely capital-intensive, at a level beyond the funding capacity of Fonterra's 12,000 NZ suppliers. National Foods and Fonterra's other consumer ventures are likely to require significant additional shareholder funds to grow. This is not widely understood among suppliers.

Third, Fonterra needs new board and management talent. The recruitment of Unilever's Sanjay Khosla to head NZ Milk is not sufficient. None of Fonterra's nine farmer-directors have adequate expertise or experience in international consumer businesses. The board overall lacks depth and breadth. A comparison with competitor boards like Nestle, Danone, Kraft, even National Foods, highlights this weakness.

Fourth, Fonterra's strategy aims to add value to its suppliers' capital, not their milk. It also requires NZ Milk to strive to meet the needs of its customers, not its suppliers. Both are profoundly at odds with the core values that explain why Fonterra is a traditional supplier co-operative and not an investor-owned company. This conflict is not recognised by many suppliers. Yet it is a key reason why NZ Milk has performed poorly for so many years.

Fifth, over the last 15 years, the idea of "growing value-added" has become a sort of economic Holy Grail. But it is a rather vapid mantra. What counts is not Fonterra's proximity to consumers on the value chain, or the sophistication of its products. What counts is its risk-adjusted profitability. Like any investment proposal, diversifying only makes sense if the expected additional profits cover the opportunity cost of the capital invested.

Whether buying National Foods meets this test is not clear. Fonterra's shareholders are flying blind, with no market for their shares and no external analysis of likely value impacts. Fonterra's structure is simply maladapted to this sort of investment activity, lacking essential performance disciplines and shareholder safeguards.

Whatever the case for or against buying National Foods, investing in "value-added" will not succeed over the medium term unless Fonterra properly addresses the core weaknesses outlined above.

Tony Baldwin

Leader, Producer Board Project Team 1999

Policy Adviser, Department of the Prime Minister and Cabinet 1991 – 98