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"Failing to deliver"

By Andrew Janes

Fonterra promised five years ago to become a sexy consumer brands company selling high-value products globally -- a promise it has failed to keep.

Andrew Janes reports farmers have reached the end of their tether, but may only have themselves to blame:

Like milk left in the fridge too long, an aroma of discontent is beginning to emanate from farmers disappointed by the performance of the merged cooperative that was supposed to save the dairy industry and lead export growth.

Fonterra, formed by political diktat and without Commerce Commission approval, in 2001 through a merger of Kiwi Dairies, the New Zealand Dairy Group and the Dairy Board, was supposed to increase revenues by 15 per cent a year for the next decade.

In a report that helped sell the merger to the Government, Andrew Grant of McKinsey & Co said the merger would deliver $19 billion of growth in new revenues from non-commodity value-added products such as nutritional milks and powders.

Helen Clark liked what she heard. At Parliament's opening in February 2001, the prime minister heralded the proposed merger as a key move in the transformation of the economy. "For too long New Zealand has been trying to sustain First World living standards on the back of Third World exports. That does not add up," she told the House.

But five years on Fonterra has not come even remotely close to delivering on its promises. Some in the industry argue that it will not be able to without fresh leadership and a radical change in the way the cooperative is structured.

Industry commentator Tony Baldwin says innately conservative farmers need to unload their historical and cultural baggage and relinquish total control of the cooperative to make it competitive internationally.

An area in which Fonterra was expected to achieve growth was in the value-add products. Selling ingredients such as milk powder to other dairy companies is fine, but in these areas Fonterra is largely a price-taker vulnerable to fluctuating commodity prices and exchange rates.

By creating and marketing new products, so the logic went, Fonterra would be able to open up new markets for dairy products and smooth out the volatility of shifting commodity prices.

But in the value-add area, Fonterra's performance has been disappointing. The value-add contribution to milk payout, a key indicator in assessing the value-add contribution to profitability, has hardly changed since the cooperative was formed.

It was 47 cents for the 2002-03 season, 48 cents in 2003-04, 45 cents in 2004-05 and 48 cents in 2005-06. "That's not good enough," says Fonterra Shareholders Association president John Monaghan.

As the representative of the 13,000 farmer shareholders, the association made its views powerfully clear in its annual report this month. The highly critical report was peppered with phrases such as "slow and reactive", "serious concern" and "lacklustre performance".

It marked the first time in Fonterra's five years that shareholders had refused to endorse the cooperative's statement of intentions for the just-passed 2005-06 dairy season.

"Increasing value-added returns was one of the key reasons for forming Fonterra," Mr Monaghan says. "As farmers, we have a significant investment in the cooperative for generating value-added returns. But it doesn't matter how you dress it -- value-add isn't performing."

When the idea for a large monopolist dairy cooperative was floated in the late 1990s the plan was to split the value-add part from the cooperative and list it.

Sniffing the winds of change, former Dairy Board chairman Sir Dryden Spring started schmoozing Labour before it was elected, speaking at the party's 1998 annual conference.

Miss Clark became convinced the merger was right for the country and over-rode nervous officials who were less sure.

The plan to separate the value-add part was shelved as soon as the merger went through. "That was going to be the basis to drive revenue growth," Mr Baldwin says. "But it died because it was so unpopular with the farmers. All the guys (on the board) who were proposing it got chopped. There's a huge mistrust of change among farmers."

Value-added products, at about 20 per cent of Fonterra's revenues, have barely changed in the past five years -- despite the boundary between value-add and commodity having blurred.

Fonterra is largely locked out of the lucrative North American and European markets because of quotas. This has led it to focus on selling branded dairy products in Asia, Australasia and South America, an area in which it is gaining traction, says chief executive Andrew Ferrier.

Anlene, a brand of powdered milk marketed as being good for bones, has been achieving 10 per cent a year sales growth in Asia, he says. Fonterra is forecasting a step-up in value-add returns this season. "That is the result of a lot of work that's been in place for a long time. Sometimes you do all the hard work and then the benefits come later."

Mr Ferrier says the single biggest factor in depressing value-added returns since the cooperative formed has been the exchange rate. Mr Baldwin does not buy that. "It's a contributing factor but it's not the root cause," he says.

"The root problem is that value-add is a new and embryonic field for Fonterra. The strategy to get out of being price-takers for relatively unprocessed products started in about 1995. The sell line for Fonterra was it was going to make a radical shift in becoming a mainly consumer-end business that would be developing high-margin products."

MR Baldwin offers three main reasons why Fonterra has failed to transform itself into a consumer-focused business selling branded value-add products.

Firstly, its whole business orientation is based on trying to increase milk volumes, he says. "The business is still dominated by milk collection, processing and distribution.

"Consumer-end businesses start with what consumers are prepared to pay and what they want. Fonterra is by definition driven by its producers and not by its customers."

Second, because it is reliant on just 13,000 farmers for its funds, Fonterra lacks the necessary capital required to compete internationally. "To be an effective consumer-end player you really need large amounts of capital because it's a risky business. Fonterra doesn't have the capital structure to enable it to do that."

Finally, it lacks directorial and managerial talent. "If you compare the quality of its board, particularly with companies it wants to be like, such as Nestle and Kraft and others, it doesn't match up. They have diverse talent across a range of fields. Nine of Fonterra's directors are farmer-elected with skills in production."

Mr Baldwin says there are international examples of better structured dairy cooperative. Netherlands' Campina has two types of shares one for farmer suppliers and the other share-market listed and available to the public. Farmers still retain control of Campina, Mr Baldwin says.

The successful dairy company Kerry in Ireland used to be a cooperative. "They just said, `We're listing'. Initially, farmers kept control but they have now sold down their shareholding and now only own about 30 per cent."

Another option would be to merge with other cooperatives, probably in Australia, Mr Baldwin says.

But is there a mood for change among Fonterra's 13 directors?

The influential Sir Dryden Spring, godfather of the dairy industry, is believed to be the leading proponent of the view that "the cooperative is sacred".

Some board members are more open to change, led, it is believed, by Earl Rattray.

Chairman Henry van der Heyden came in promising change but has not delivered.

This goes back to the 1890s when dairy farming was pioneered in New Zealand and the cooperative structure was introduced by the Liberal government of Dick Seddon, Mr Baldwin says. "The overwhelming mainstream of farmer opinion is that it (Fonterra) has to be owned by farmers because anyone else will rip you off."

That five-year-old milk in the fridge is starting to get even smellier. Soon it will have to be chucked out or it will turn into yoghurt.

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