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UP IN THE AIR

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Fonterra is gearing up for the biggest decision in its five-year history. Andrew Janes looks at some of the options to overhaul our biggest exporter.

IT ALL gets back to the milk price, reckons Waikato dairy farmer John Bluett. "That's the basic guts of it." He's talking about the reasons why most dairy farmers regard the prospect of letting non-farmers invest in Fonterra with suspicion.

"At the moment, as a cooperative, we're driving the thing for the benefit of the members. But if you do a public listing then you put another tension in there. One guy is going to want the milk price good, the other guy is going to want the milk price excellent."

New Zealand's biggest exporter and only truly global company raised the prospect of some form of public listing just before Christmas when it announced it was undertaking a major review of its capital structure.

Driving the review are two core challenges Fonterra is facing: how to reduce the so-called redemption risk -- a run on the balance sheet if too many farmers leave the cooperative -- and a desire to bring in new capital to fund growth.

Fonterra's board and senior management are trying to reconcile those needs with maintaining farmer control and a cooperative structure -- two things they have said are non- negotiable.

They're not talking publicly till a preferred option is unveiled at Fonterra's annual meeting in September.

That will be followed by several months of vigorous debate before a vote that will need the support of at least 75 per cent of Fonterra suppliers.

Mr Bluett, who farms at Te Pahu, near Hamilton, is reserving judgment till he sees Fonterra's preferred option. But he says the board will have to make a very convincing case if it goes for some form of listing.

"Our forefathers have built the industry to where it is today and if our generation is the one that loses control of it by the decision we make right now then we're going to be accountable for that.

"To actually give part of it away there would have to be a hell of a good reason."

If Fonterra is to succeed in pushing through major change it has got its work cut out to carry along at least three-quarters of its shareholder base.

Sources close to Fonterra say that while senior management is keen on substantial change, the board is more divided with some directors urging caution because they don't want to alienate shareholders.

"My personal opinion is that they're looking at a series of options and are coming up against brick walls," one source says.

"For the majority of the farmer base it's about ownership and control. It's very difficult to give up some of the former without losing some of the latter.

"Whatever they do, they've got to make it palatable and that's going to be a struggle quite frankly."

Dairy industry commentator Tony Baldwin sees listing as the most effective way of addressing the redemption risk and bringing in new capital.

"The challenge is to find a structure that delivers those two major requirements, while somehow accommodating the deeply held view that the cooperative is sacrosanct," he says. "It's hard to reconcile the two."

Mr Baldwin says if Fonterra does take the listing route, it will most probably cease being a cooperative.

However, a Fonterra shareholding cooperative would be formed which would control a majority of the shares. Farmers would vote within the shareholding cooperative rather than as individual shareholders and in this way would maintain control of the company.

"The key thing that they want to do is make sure the cooperative is still visible and in control," Mr Baldwin says. "That would tend to push them in that direction."

If Fonterra's board isn't confident of winning enough support for a listing there are other options it could look at.

Former Canterbury University accountancy lecturer Alan Robb advocates changes to the fair value share system.

Fonterra suppliers hold one fair value share for each kilogram of milk solids they supply and have to buy or sell fair value shares when joining or leaving the cooperative or changing their production volumes.

"I don't believe the fair value calculation is a reliable one," Mr Robb says.

"It should be based on net tangible assets rather than guesstimates about future earnings."

Mr Robb also wants to see farmers receive an annually-reviewed dividend on capital -- at a small premium to Fonterra's bank borrowing rate -- they put into the cooperative. He favours Fonterra distributing an annual surplus to farmers after it has retained a prudent amount for expansion.

This would replace the value-add component in the payout, "and it would be much more transparent".

Chris Kelly, chief executive of Landcorp (one of Fonterra's biggest suppliers), supports a change to the capital structure but says a listing might be too radical for Fonterra shareholders. "I think it's going to take a bit more time and education before the majority of shareholders will be comfortable with outside equity in Fonterra."

He suggests a model similar to that used by Livestock Improvement Corporation, which would allow Fonterra suppliers to trade shares amongst themselves but not with outsiders. Under this model there would be two types of shares. One type of share would be traditional cooperative shares, 100 per cent linked to milk supply. These would be non- tradeable voting shares and farmers would receive a return on them through a commodity milk price.

"The more they try and put a structure together that retains what the traditional [cooperative] guys want, the less the achieve their objectives and they end up being a three-humped camel" – Tony Baldwin

Meanwhile there would be a second class of tradable value-added shares for which farmers would receive an annual dividend. These shares would give farmers some ability to choose their level of investment in Fonterra.

"This might be more palatable to farmers than a listing in the first instance," Mr Kelly says. "It would also mean that if the tradable shares were to be opened up to the public at some point in the future it would be a lot easier because all that structural separation would have already been done."

Ultimately, if Fonterra's board hopes to push through big change its has to convince its shareholders to buy into its global growth strategy, which involves sourcing an increasing amount of milk supply overseas.

Dairy Farmers of New Zealand chairman Frank Brenmuhl says he does not think Fonterra has explained its strategy of building new dairy industries in places like China well enough yet. "Farmers are having some difficulty in seeing how they will benefit from this."

Growing the business quickly could increase the redemption risk by pushing up the value of the fair value shares, he says.

Both Mr Robb and Mr Baldwin say Fonterra's global growth strategy is incompatible with its cooperative structure.

The capital structure review is also taking place against a backdrop of record high international dairy prices and the emergence of new local competition such as Affco's Dairy Trust venture.

Mr Kelly says the increased local competition make the capital structure review more urgent.

Mr Bluett says Fonterra's cooperative structure is an important protection mechanism. "That 75 per cent hurdle might slow the process down but at the end of the day the industry will probably end up making the right decision," he says.

"It means that management and the board have to do their homework and take the farmers with them. And that's how the industry has worked for the last hundred-odd years and that's probably the difference between a cooperative and a corporate."
