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Milk 'n' money go hand in hand

By Andrew Janes

Fonterra is flagging a big increase in its overseas investments. ANDREW JANES looks at how the money will likely be spent and some of the risks involved.

Ten-digit numbers roll evenly off Andrew Ferrier's tongue. The Fonterra chief executive is outlining the dairy co-op's global growth strategy and it is safe to say Fonterra cannot be accused of sitting on its hands.

"We're looking at $3 billion of investment over the next three to five years," he says.

"And if there's a large acquisition that becomes available in a region that's right on strategy it could be $1b or $2b more."

These types of numbers represent a seismic shift in Fonterra's offshore expansion. By comparison it spent $484 million on investments in 2005-06 and $331m in 2004-05.

Sitting behind the aggressive growth strategy is the belief that offence is the best form of defence against the emergence of new low-cost dairy producers around the world.

Says Ferrier: "If we were to stand still it's our view that you are going to see other players coming in and taking over the footprint that we have today. And over time we would become more of a regional player than a global player."

According to Ferrier, the investment will be driven by a four-pronged strategy which Fonterra has been following, with some minor tweaks, since its formation.

What he describes as the four key thrusts are:

- Ensuring Fonterra remains the lowest-cost producer.
- Most sustainable dairy producer over the long term

- Continuing to strengthen its ingredients and consumer brands offerings.
- Strengthening its market position by sourcing milk from different parts of the world and replicating its supply chain -- or creating mini-Fonterras -- in markets where it is not practical to import product from New Zealand.

But are Fonterra's farmer- shareholders keen to go along for the ride? "The shareholders are keen to see Fonterra grow," Fonterra Shareholders' Council chairman Blue Read says. "But they need more surety about where it (future investment) might go and what it might return and whether the returns are going to be in cash or through the fair value share.

"Farmers also want to be very clear that our productive base in New Zealand and the returns we get from it isn't going to be threatened by the production of cheaper milk offshore."

"There will be a few farmers out there who will be concerned that some Fonterra executives may have a view that growing the company is too much of a focus as opposed to growing shareholders' wealth," says Dairy Farmers of New Zealand chairman Frank Brenmuhl.

"Farmers want to know how much would need to be invested, where it would be invested, does it alter control of the company, does it change the way in which returns would be brought back to farmers and how long would it be before those returns are expected to come."

Brenmuhl says he believes more information will be forthcoming when Fonterra reveals its preferred capital structure and gives more detail on its growth strategy at its annual meeting in September.

Fonterra's overseas investment will be focused on strengthening its presence in the areas where it is already active, Australia, Latin America, China and the United States, Ferrier says. Because a lot of the growth, in China and Latin America in particular, is coming in the liquid milk area, Fonterra is strengthening its behind- borders presence and replicating its global supply chain in these markets.

Fonterra describes it as going from the cow to consumer -- sourcing and processing the milk and manufacturing and selling dairy products in these markets. "We started focusing on growing behind borders when we formed Dairy Partners of America (DPA) in 2002 with Nestle in South America," Ferrier says. "That was for the most part an internal play in South America. We are in Brazil, Argentina, Colombia, Ecuador and Venezuela. And for the most part we are collecting local milk and it's going right up through the supply chain and we're selling it as consumer products.

"The same thing is happening in Chile with our investment in Soprole," he says.

There is a proposal on the table to roll Soprole into DPA, Ferrier says.

In the US, Fonterra is producing milk-protein concentrate through its joint venture with Dairy Farmers of America.

"We are looking for more growth out of DPA in South America. That's one of our key focuses. We want to put some oomph behind growth there. Organic growth rates are picking up but DPA remains interested in acquisitions in Latin America. We certainly have them on the radar screen.

"We will also be focusing a lot on China to move further along over the next two to three years," Ferrier says. Much of this growth will come through SanLu -- a Chinese company that Fonterra has a 43 per cent stake in. If its pilot farm in China goes well Fonterra is looking at setting up a lot more of its own farms both in China and possibly in other parts of the world, although Ferrier will not say where.

Across the Tasman, Fonterra is keen to grow in the liquid milk and yoghurt areas.

"We've been consistently on the hunt to get a larger footprint in milk and cultured products," Ferrier says.

Potential acquisition targets include National Foods, Dairy Farmers (due to list next year) and Parmalat.

"We're certainly interested in looking if the opportunity comes up for future acquisitions," Ferrier says.

"But I wouldn't want to put an emphasis on any one player in particular."

Farther out, Fonterra may look to invest more in Eastern Europe.

"It's on our radar screen. We have a small position there now. It's just a little further down the track than the ones we are concentrating on. The reason we would be interested is two-fold. It's a potential source of low cost milk and it gives us the opportunity to supply fresh milk in a region."

By sourcing more milk from different parts of the world Fonterra can strengthen its relationships with its major customers and supply them more milk, Ferrier says.

"In order to get a really good relationship with a customer we have to be a multi-origin supplier.

"By being able to supply more from around the world, we're actually able to supply more from New Zealand," Ferrier says. "We might have been supplying them (big customers) 40% of their requirements. Now we are supplying 70%, and 80% of that is coming from New Zealand."

So how does Fonterra intend to fund its aggressive growth plans? According to credit ratings agency Standard & Poor's, Fonterra's current debt to equity ratio is 53.9%, above its preferred 45 to 50% range. Debt-funded acquisitions, especially in higher risk geographies would likely have negative implications on Fonterra's A+ credit rating, says S&P in a recent research note.

Dairy industry commentator Tony Baldwin says Fonterra would not be able to fund its planned investment levels from debt alone. "The banks would regard that as too risky," he says. "And I think that it would be too risky for the business. It would expose them quite a lot."

Ferrier concedes that $3b of investment would stretch Fonterra's balance sheet capacity. "That's one of the reasons we have the whole capital structure issue on the table."

Baldwin says he is not sure if Fonterra has the directorial and managerial talent to implement and manage the rates of growth it is talking about. "They're good at what they do from their New Zealand base. But are they good at replicating that in other countries?" he says.

"What's their track record in other countries? The short answer is I don't know because there's never been any really good information on it.

"What really counts is does Fonterra have a framework in place so it's able to be highly responsive and adaptable to changing circumstances and allows shareholders to adjust their position? And the answer is no. There isn't external monitoring and there isn't a share price which adjusts on the time frames that the business circumstances are changing. And the shareholder doesn't have the opportunity to pull out if they don't like the smell of it."

Ferrier says Fonterra's size and its expertise across the entire supply chain make it ideally placed to leverage its skills in new markets and apply them with partners. "I've been in farmer meetings across the country and there's very strong support for our strategy.

"Dairy farmers in New Zealand built this expertise and this global reach and if we can create these mini-Fonterras in the markets that we know are going to show the most growth then our farmers, who are our shareholders, are the beneficiaries." Dairy Equity E6

CAPTION:

Tony Baldwin: funding from debt alone "too risky". Frank Brenmuhl: farmers want to be kept informed. [Andrew Ferrier]