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Fran O'Sullivan: Fonterra nicely set to see off tougher competition

Fonterra is exquisitely poised on the brink of a strategic shift that should enable it to stay ahead in an increasingly competitive market.

Fonterra directors were in nationwide discussions with their dairy co-operative shareholders for much of last week regarding the direction in which they want to take New Zealand's largest company.

The much talked-about capital restructuring - which is expected to result in a full or partial listing on the NZX - is gaining considerable support from the co-op's dairy farmer shareholders.

Initially sold into the market late last year as a mechanism to reduce the risk of older shareholders leaving the co-op and causing a run on capital, the proposal has now developed a strategic colour.

Fonterra's export monopoly rents - the millions of dollars it extracts from its rights to NZ dairy quota in protected markets like the European Union - are now up for review.

New competitors, like meat processor Affco, which formed wholly-owned subsidiary Dairy Trust to get into the dairy processing industry, are muscling in on Fonterra's domestic turf. Affco will also list Dairy Trust on the NZX next year, providing sharemarket investors with direct exposure to NZ's biggest exporting industry and with a benchmark against which Fonterra shares will ultimately trade.

Other niche operators are also biting at Fonterra's heels, poised to drive their own exports further into international markets, as the giant co-op becomes bogged down in discussions over what happens to the legislated stranglehold it has enjoyed on NZ-denominated dairy quotas.

On top of the domestic issues, Fonterra faces downstream costs if the Government opts for a draconian approach to apportioning NZ's climate change risks.

In essence, the proposed capital restructuring will be designed to:

- Address the redemption risk issue that the company faces;
- Introduce flexibility so that farmer or agricultural company shareholders have the ability to ensure that not all their eggs are tied up in one investment basket;
- Introduce new capital so that Fonterra can further its ambitions in an international environment where other competitors like the burgeoning Chinese multinationals Mengiu and Yili are fast morphing into traders, not just domestic suppliers.

Critics like Andrew Robb were still barking from the sidelines this week that any demutualisation of the co-op would cause farmers to lose control of their livelihoods. Robb is also critical that a partial listing - say with 40 per cent of Fonterra's equity capital being offered as "investor shares" - would reduce farmer clout and cause divisions.

This theme has also been picked up by NZ First, which is desperate for news issues to ballast its low political poll ratings.

The key point that neither Robb or NZ First address head-on is that Fonterra is now feeling pressure in a competitive international environment where its dominant position as the key exporter is increasingly being challenged.

For instance, Mengiu has formed a joint venture with Denmark's Arla to introduce new products to the Chinese market.

This begs the question over whether Fonterra should form a similar alliance with the Chinese giant's main competitor Yili, on top of its existing shareholding in the smaller Sanlu company, so it can maintain its relative position.

More details over Fonterra's strategy and the proposed capital restructuring will emerge tomorrow morning, when chairman Henry van der Hayden, CEO Andrew Ferrier and strategist Graham Stuart brief reporters at its Auckland HQ.

Timing, of course, is everything.

World dairy prices are still strengthening, and the company is saying it will pay at least $4.50 a kg of milk fat solids to its farmer shareholders next season.

With this expected to result in about $420m extra in farmers' pockets next year, it is perhaps no wonder that they are now optimistic enough to contemplate the substan-tial change that is necessary for them to stay in the long-term game.

Importantly, the board - which includes some top-flight independent commercial directors as well as shareholder representatives - is united on the strategy.

There has been no public kickback or personal outbursts directed at the directors or executive over the past week.

This was not the case with another of the boards on which van der Hayden is represented.

At the NZX annual meeting in Wellington on Friday, chairman Simon Allen confirmed that the board had "stuffed up" by not consulting its major shareholders before announcing a new CEO share scheme for NZX boss Mark Weldon.

The scheme would have seen Weldon emerge with 9.9 per cent of the NZX within three years if he met the target of increasing total shareholder returns by 10.5 per cent a year on a compounding basis.

To his credit, Allen took personal responsibility for the mess after being invited to say who would be held responsible by shareholder and reporter/analyst Brian Gaynor.

The reporter said media reports had been one-sided and intimated that the board had failed to get across its reasons for supporting the share scheme.

Allen said the board would consult shareholders as it worked up a replacement package, which he expected to be in place by the middle of the year.

The NZX chair as good as admitted there was an element of tax design to Weldon's overall remuneration package.

But it is still unclear whether the NZX has sought a binding ruling from the IRD on the issue.

That's where the issue probably should have stayed.

But Weldon, who is not short of opinions on the quality of the business press, repeated his view to a Wellington newspaper that media discussion around the issue had been "destructive", instead of signalling that maybe the major shareholders' views should be given credence.

Unfortunately for Weldon, those remarks, coupled with the unusual statement he made to the NZX saying he had encouraged and endorsed the board's decision to withdraw the scheme, will be read by some major shareholders as indicating that the CEO is not happy to let Allen take the lead on such issues.

If so, the internal fence-mending should take place before the NZX goes public again.

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