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Fonterra's evolution vital for industry

By Andrew Gawith

Change is needed to make the most of dairying, writes Andrew Gawith, director of Gareth Morgan Investments, an investment manager, KiwiSaver and superannuation provider.

While the New Zealand public has been curdling over the price of milk in supermarkets, there have been interesting developments affecting the "other" price of milk: the price that farmers receive.

Fonterra and the Government are consulting on a proposal to offer the public a stake in the dairy giant by creating non-voting shares. But could such a deal turn sour for investors?

For decades investment in our lucrative dairy industry was restricted essentially to farmers. As a result farmers, through the Dairy Board, and now Fonterra, effectively own a lot of the processing, distribution and even brands under which New Zealand's milk is sold.

The idea was that this "co-operative" model would prevent foreign dairy giants such as Nestle from setting up shop, wiping out all competition and eventually turning farmers into serfs on their own turf.

In some ways this co-operative approach has been successful. By owning the whole value chain, farmers have definitely avoided becoming serfs, and have got good wholesale prices as a result.

They have been able to reinvest the proceeds and make their farms some of the most efficient in the world. But there are downsides to this approach and these have led to continual tinkering.

For starters the co-operative model has made it difficult to access outside capital to fund growth. So while the likes of Nestle have been growing rapidly, the growth of Fonterra and its predecessor the Dairy Board has been relatively slow, with most of the profits going back to farmers, their farms and the odd boat and bach. There have been plenty of non-farmer investors clamouring to invest in one of our largest and most lucrative industries.

The farmer shareholders tend to judge the value of their investment in Fonterra (wrongly but understandably) by the price they are paid for raw milk. Certainly, they are very keen to have all surpluses returned to them when milk prices are low, thereby stunting Fonterra's ability to consistently invest in developing new products and new markets.

By tying profit distribution so heavily to the raw milk prices it distorts the investment signal in favour of production and away from market and product development, areas that may pay steadier and larger dividends over the long term.

What is happening is that a lot of the value Fonterra is generating is being capitalised into land prices, which is a great tax-free bonus for existing farmers.

But it means that fewer young people can hope to become full owner-operators. Rather they will work for largely city-financed, land-owning syndicates as managers or share-milkers, or - heaven forbid - foreigners with deep pockets and good access to rapidly growing markets.

Fonterra is proposing yet another change to the co-operative model to give it greater access to capital while still retaining farmer control. It will allow Kiwis to invest in the dairy giant, but through a trust model so non-farmers won't have voting rights.

Fonterra would also remove its obligation to buy and sell shares to farmers who want to increase or decrease their milk supply, as has been the case to date. This would be left to two markets, one between farmers and one with non-voting investors.

What's in it for potential non-farmer investors? Access at last to one of New Zealand's most successful large-scale industries, which appears to have a bright future given the rapid growth in household wealth in Asia.

But this is an equity investment with no voting power to influence the board, strategy or returns - no matter how good it looks this is a partial float of an odd corporate structure with no voting rights. It could turn to yoghurt.

Fonterra's profit (and therefore the return for non-farm investors) is heavily dependent on the price Fonterra pays for milk.

Milk after all is Fonterra's main cost - so the more it has to pay for milk the less remains as "profit" to be paid as a dividend to shareholders.

The trouble is that the milk price, not the dividend, is the major source of income for farmers, who have total control of the business.

Non-farm investors will easily be dissuaded from providing additional capital if the dividends are too small and erratic. When things are going well there is no reason to think there will be a problem - Fonterra will be able to keep both farmers and investors sweet.

The way Fonterra sets the milk price is about as transparent as a glass of milk itself. Before wading in investors will need more information and confidence in how the milk price is set.

Fonterra has suggested setting up a separate milk price panel, with a majority of independent (non-farmer) members. This might be a good start but greater transparency will be needed. That will hopefully be the feedback the Government gets from its current consultation.

Fonterra is slowly evolving into a more conventional business and that is vital if it, and this country, are going to maximise the longer-term value that the dairy industry offers.

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