Feature

The TROUBLE with FONTERRA

Fourteen years after the dairy giant began, we're still waiting for the promised economic transformation, says **Tony Baldwin**

"Potentially better than an oil well," boasted Fonterra's founding chairman John Roadley in 2002.

"White gold" is another favourite label. Over many decades, New Zealand has invested massively in raw milk as a pathway to economic prosperity. It's why Fonterra was formed.

But with the collapse of international dairy commodity prices and Fonterra's recent announcement of low payouts for the 2014-16 seasons, the oil and gold metaphors don't seem so apt.

This wasn't supposed to happen.

Created in 2001 by special legislation overriding the Commerce Act, Fonterra was heralded by industry leaders and key advisers as an "icon of economic transformation", a "breakthrough idea", "helping New Zealand catch the knowledge wave" and "moving us up the value chain".

As a near-monopoly dairy processor collecting 96 per cent of all raw milk in New Zealand, the vision was that by 2011 Fonterra would generate $19 billion of new revenue using milk proteins and enzymes to make pharmaceuticals, health foods, specialised ingredients and high-margin consumer foods. It would also deliver efficiency gains of at least $300 million.

Outcome vs vision

Fourteen years on, Fonterra is doing fundamentally the same things it did in 2001. It still collects the lion's share of the raw milk in New Zealand and turns it into mainly milk powder, cheese and butter, which it still sells in relatively basic form in more than 100 countries.

It has a patchwork of overseas businesses and partnerships in higher value market segments, but these are still a small proportion of its overall earnings, which has not grown significantly for many years. Its growth and return rates are well short of the vision.

So what has changed since 2001? In a nutshell: volume and China.

Raw milk production in New Zealand has increased 58 per cent. More cows (up 33 per cent), more milk per cow (up 21 per cent on average), more land used for dairying (up 22 per cent), more investment in milk processing plant, more on-farm plant and equipment, more water for irrigation, more waste, more cow genetics, more pasture management, and of course, more borrowing. Dairy debt almost trebled over the past decade to reach $32 billion last year.

In short, New Zealand dairy farming is considerably more intensive and our production of low value commodities and ingredients, especially milk powder, has mushroomed.

But while volumes have increased, so have costs. For a long time New Zealand was the cheapest producer of raw milk in the world. In the past decade or so we've lost that ranking to Argentina and Victoria, with California reported to be running close.

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At the farm level, much of the growth in raw milk is probably not profitable. Analysts say that less intensive production is likely to deliver a better bottom line for farmers and the environment. Analysts also say that few farms cover their full economic costs. Rather, they rely on farm land values increasing to deliver untaxed capital gains. The problem is that rising land prices have not been supported by farm earnings.

On the demand side, the big change has been China, where our 2008 Free Trade Agreement has been crucial. In 2013, New Zealand supplied over 70 per cent of China's total dairy imports, and 90 per cent of all dairy exports to China in 2014 were milk powders and products derived directly from powders.

Certainly, there have been other changes and gains since 2001 but overall Fonterra is still confined largely to segments of the dairy business with the potential to deliver a return on assets of no more than around 5 to 8 per cent.

It has some useful medium-margin positions in Asia, Africa and the Middle East in nutritional products and food services, but these are relatively niche. And Fonterra's revenues from its higher value consumer business have been essentially flat for many years.

Like its co-operative peers around the world, Fonterra's business is dominated by the low value end. Put plainly, it is still a "bottom feeder".

There has been no economic transformation, only intensification.

By contrast, companies like Nestle, Danone and Kraft make and sell dairy products with much higher margins and deliver much stronger returns on assets. Prices for their higher value products tend to be much less volatile, and the companies' risks are spread more widely across diversified global food businesses.

About the author
Tony Baldwin is a dairy industry commentator and was leader of the Government project team responsible for facilitating the deregulation of New Zealand's producer boards in 1999.

Why hasn't it worked?

"Moving up the value chain" is hardly a new vision for New Zealand dairy. Industry leaders have been repeating the same mantra for at least the past 25 years. In 1989, then chairman of the Dairy Board Sir Dryden Spring set the goal of lifting the proportion of valued added products "as close to 100 per cent as we can get as soon as possible".

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Fonterra was supposed to be a breakthrough. Why hasn't it worked? Six factors stand out.

■ First and foremost, successful consumer-end businesses are designed and driven by what consumers like and don't like, and how much they will pay. By contrast, Fonterra is driven strongly by its producers. Increasing volumes and holding market share take precedence over moving up the value curve.

Reinforcing this volume and production focus, legislation requires Fonterra to take all milk supplied by any New Zealand dairy farmer, whether it is wanted or not, and no matter how distant from processing facilities. Fonterra's milk payout makes up 80-90 per cent of a dairy farmer's income, so unless he or she has resources and skills to increase income from other sources, dairy farmers perceive that they can grow their earnings only by increasing milk volumes.

■ The second key factor is an apparently deep misunderstanding by Fonterra of its strengths and weaknesses. In Fonterra's strategic outlook, covering every step in the supply chain — from farm vat to retail consumer — gives it a major advantage over competitors. It boasted in 2007: "we do it all. We can take this expertise and apply all or part of it in any market."

However, expertise in commodities manufacturing and distribution does not give any special competitive advantage in downstream markets. They are quite different businesses requiring quite different resources and skills. Consumer dairy markets are also relatively full and the existing players — like Nestle, Danone, Kraft and others — are well established.

Fonterra trying to move deeper into those higher margin segments would make sense only if it was likely to earn returns that fully reflected the considerably higher risks it would face. In its current configuration, there is no basis for concluding that Fonterra is likely to succeed.

■ The third key factor is confusion and tension in Fonterra's objectives and roles. Fonterra tries to be many things to different people. Shortly after it was formed, Fonterra described itself as a "dairy farmers' co-operative, a multinational marketing company, and an international capital investor". Compounding this chameleon self-conception, Fonterra's statements of company vision and strategy tend to embrace all parts of the value chain. The result is a muddle.

■ Fourth, building a successful higher value dairy business in overseas markets is extremely capital intensive. But Fonterra is capital constrained. It can raise equity from only two sources: its 10,500 farmer-shareholders, who have limited capacity; or retaining part of its profits, but this is also difficult given farmer pressure for maximum payouts.

Trading Among Farmers (TAF) and the Fonterra Shareholders' Fund (FSF), introduced as a package in 2012, did not deliver any additional capital. And since TAF, there has been virtually no new equity capital put into Fonterra.

■ Fifth, the capital that Fonterra has is channelled mainly into plant and equipment for processing raw milk in New Zealand, which dominates its business. Growth in capital expenditure has been greater than growth in selling and marketing expenses. As Arie Dekker from First NZ Capital highlights, this push into more stainless steel "is a real constraint on the pace with which Fonterra can realistically turn the wheel".

■ The sixth key factor is weak governance and limited capacity to execute. Fonterra has 13 directors: nine dairy farmers elected by supplier-shareholders and four independents appointed by the other nine. So the board's expertise is heavily weighted toward milk production and processing. A wider range of talent is required to successfully grow higher value businesses.

Inadequate information disclosure and weak monitoring are important related problems. Having the FSF in place has improved things to some degree, but external monitoring of New Zealand's largest company is still sub-standard. Highly fragmented ownership by 10,500 farmer-shareholders makes robust and well-directed shareholder monitoring almost impossible. Fonterra's Shareholders' Council is more akin to a members' consultation group.

Options for change

Put simply, Fonterra's strategy is at odds with its structure. This was clear when Fonterra was formed. From a big picture perspective, it has two choices: change its structure to enable its strategy or change its strategy to reflect its structure.

Real structural change has proven to be too difficult. The 1999 proposal for a single national dairy co-operative had its consumer business separated into a listed company with a large amount of non-farmer equity capital injected. But this was unacceptable to most industry leaders.

In 2007, Fonterra's board really pushed the boat out with a proposal to float Fonterra as a whole, like Kerry, an Irish dairy co-operative that morphed into a successful international food business. This was way too much for Fonterra's conservative membership.

Other options have been considered, including the idea of merging with dairy co-operatives in other countries. But this wouldn't address Fonterra's underlying limitations.

In the past year or so, several new advocates have surfaced in favour of separating Fonterra's foodservices and consumer business, including Professor Keith Woodford at Lincoln University. But among supplier-shareholders, Fonterra's status as a co-operative controlled 100 per cent by its farmers is sacrosanct. There is a deep-seated distrust of any structure that might allow non-suppliers to share in potential gains from suppliers' milk.

As industry godfather Sir Dryden Spring declared in 2001 when urging New Zealand dairy farmers to vote in favour of forming Fonterra: "either the industry moves forward united, firmly in farmer hands with farmers reaping the benefit of participating in value-added marketing, or it allows those benefits to belong to others".

Fonterra's approach and options are heavily proscribed by articles of faith that are deeply held among its farmer-shareholders: maximise the milk price paid to farmers, process and market the milk collected every day from member farms, maintain 100 per cent farmer control, distrust and exclude outside investors, minimise competition within New Zealand, and grow volumes.

As progressive former industry leaders like John Storey and Graham Fraser can attest, farmer politics gives no quarter to those seeking to apply a more progressive approach to these covenants of co-operative membership.

In short, industry politics continues to preclude any major change to Fonterra's structure.

Where to from here?

Despite its fundamental weaknesses,

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