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“FONTERRA 14 YEARS ON”

By Tony Baldwin

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This is a longer version of an article by Tony Baldwin that appeared in the printed edition of NZ Herald’s “The Business” on Friday 28 August 2015. In the following order, it looks at:

- *Fonterra now against the vision when it was formed;*
- *How farmers and shareholders have fared;*
- *What “higher value” means;*
- *Why the value-added dream hasn’t been achieved;*
- *What Fonterra should do from here;*
- *The Australian perspective; and then*
- *A brief conclusion.*

“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 – 2016 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 “break-through idea”, “helping New Zealand catch the knowledge wave”, and “moving us up the value chain”.

As a near-monopoly dairy processor collecting 96% of all raw milk in New Zealand, the vision was that by 2011 Fonterra would generate $19 billion of new revenues 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 versus vision

14 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 over 100 countries.

It still has a patch-work of overseas businesses and partnerships in higher value market segments, but these are still a relatively small proportion of its overall earnings, which has not grown significantly for many years. Fonterra’s 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%. More cows (up 33%), more milk per cow (up 21% on average), more land used for dairying (up 22%), 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 borrowings. Dairy debt almost trebled over the past decade to reach $32 billion last year.

In short, New Zealand dairy farming has become 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 last decade or so, we've lost that ranking to Argentina and the State of Victoria, with California reported to be running close.

On the demand-side, the big change has been China. Demand for protein from its burgeoning urban middle class has risen rapidly. In 2013, China's dairy imports increased by 50%. In the same year, New Zealand supplied over 70% of China's total dairy imports. Our 2008 Free Trade Agreement with China has been crucial.

In the China dairy market, milk powder has been key: 90% of all dairy exports to China in 2014 were milk powders and products derived directly from powders. 34% of New Zealand's total dairy exports by value were shipped to China as milk powder.

Professor Keith Woodford of Lincoln University opined last month that "without China and without dairy, then New Zealand would indeed be in long term trouble". However, Prof. Woodford remains "very confident that in the longer run China will come to the rescue and that our dairy industry will flourish".

India is another strong source of potential demand growth.

However, Europe and the USA have the capacity to increase their dairy exports to a degree that can readily dwarf any increases coming out of New Zealand. As Infometrics, an economic consulting firm, highlighted last year: "Northern Hemisphere dairy producers still pose a significant competitive threat over the medium-term", particularly with the abolition of milk production quotas in Europe from April this year.

North America is perhaps an even stronger medium term threat. Canada in particular has the potential to massively increase dairy production based on cheap prairie wheat.

International prices for dairy commodities are likely to remain inherently volatile and Fonterra's prospects of winning the race for market share are not assured.

Certainly, there have been other changes and gains since 2001 but, from a big picture perspective, Fonterra is still confined largely to segments of dairy business that deliver a return on assets of no more than around 5% to 8%.

Put plainly, it is still a "bottom feeder". There has been no economic transformation, only intensification.

How have dairy farmers and others fared?

For many dairy farmers during much of Fonterra's 14 years, returns on assets and equity from farming operations have been poor. Analysts say that few farms cover their full economic costs (which include land, labour and capital) from farming.

The Ministry of Primary Industries' model dairy farms show accounting surpluses on farm assets of less than 4.5% on average for 2008 to 2013. Profits and surpluses for reinvestment were highly variable.

Last year, industry consultant, Peter Fraser, and two colleagues surmised in a paper that farmers accept these uneconomic outcomes as part of "building a stake" in the industry and accumulating assets that will, in due course, deliver untaxed capital gains. From this perspective, farmers see their income as sufficient if cash flows cover farm costs, drawings and debt, but not necessarily their labour or equity.

As former Reserve Bank Governor, Alan Bollard, observed back in 2006: "it has become increasingly hard to try to rationalise prices paid for land using estimates of the future flow of income from the land".

Peter Fraser and his two colleagues also suggest that much of growth in raw milk volumes is probably not profitable. They surmise that volumes have been increased as a result of farmers and their advisors taking an average cost rather than marginal cost approach. Fraser concludes that less intensive production is likely to be more profitable for farmers and better for the environment.

Current Reserve Bank Governor, Graham Wheeler, voiced concern last year about the higher costs of this on-farm intensification requiring higher milk pay-outs for farmers to break-even.

In 2012, Ministry of Primary Industries estimated that the top 10% of dairy farms needed a break-even payout of $4.79; the bottom 10%, $6.96. DairyNZ says the average break-even milk price now $5.75.

Fonterra's revised estimate for 2015 of $3.85 will cause real pain for most farms.

From a Fonterra shareholder perspective, results for the last several years have also been poor. Dividend yield has varied from 1.3% to 8.6% with an average of 5.8%. During this time, the share price has been as high as $8.00 but is now trading at around $5.00.

In terms of local competition, Fonterra is still dominant in the domestic raw milk markets. Only three key competitors have emerged in the last 14 years: Open Country, Synlait and New Zealand Dairies. Together they account for about 12% of milk collected in New Zealand.

In the domestic market, Fonterra is still governed by detailed regulations and rules that set the price Fonterra pays farmers for raw milk and the price Fonterra charges other processors for raw milk supply. The Commerce Commission is currently reviewing the state of competition in the dairy industry.

What does "higher value" mean?

"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 last 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% as we can get as soon as possible".

But what does it mean?

Some dairy products have higher margins between sales price and cost. Some have a higher value per kilogram. For example in 2012, blue-vein cheese, infant formula, condensed milk, and caseins were all worth more than US$9.50 per kilogram. By contrast, cheese, milk powder and butter were worth less than US$4 per kilogram.

And some of the steps in a product reaching its point of sale to consumers are more valuable than other steps – for example, according to management consulting firm, Coriolis, manufacturing infant formula typically earns around 30% on assets, while making its milk powder ingredients earns only around 9%.

Dairy co-operatives around the world focus mainly on the low value steps of processing raw milk and selling the commodity ingredients they manufacture from it. According to Coriolis, this activity earns returns of no more than 1% - 8% return on assets and 1% - 4% return on sales. Prices for those dairy commodities also tend to be relatively volatile.

By contrast, publicly listed dairy companies like Nestle, Danone and Kraft make and sell dairy products with much higher margins of around 15% or more. Prices for these products tend to be much less volatile. And the companies' business risks are spread much more widely. For Nestle and Danone, dairy has become a smaller part of their diversified global food businesses.

Like is its co-operative peers around the world, Fonterra's business is dominated by the low value end. 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.

Contrary to industry claims in 2001, forming Fonterra did not create "critical mass" to achieve its value-adding vision. As UK consultants, Promar International, noted in their 2001 report for the Ministry of Agriculture and Fisheries, the minimum efficient scale of production for global food companies, whose core activity includes the production of milk and dairy products, was a total asset base in excess of $67 billion and revenues of $111 billion. Fonterra's revenues then were $10 billion. After 14 years, they are still only $22 billion.

Why hasn't it worked?

Fonterra was supposed to be the break-through that would make it possible to move New Zealand dairy revenues up the value chain. Why hasn't it work? Six factors stand out.

Production-driven

First and foremost, successful consumer-end businesses are designed and driven by what consumers like and don't like, and how much they are prepared to 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 pay-out makes up 80-90% 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 only grow their earnings by increasing milk volumes.

Misunderstanding strengths and weaknesses

The second 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 its 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 down-stream markets. They are quite different businesses requiring quite different resources and skills.

Further, consumer dairy markets are already 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 only make sense if Fonterra were 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.

Confused roles and objectives

The third key factor contributing to Fonterra's apparent inability to get more of its business into high value segments is confusion and tension in Fonterra's roles and objectives.

Fonterra tries to be many things to different people.

Fonterra's key cooperative goal of maximising the milk price paid to supplier-members pulls it in one direction. But its corporate goal of growing dividends and share value pulls it in another direction.

Fonterra is also an international investor using shareholders' capital to invest in overseas milk supply and down-stream businesses from which it aims to deliver a return on capital.

Thus Fonterra has 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 vision and strategy tend to embrace all parts of the value chain.

The result is a muddle.

Capital constrained

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. This was noted by credit rating agency, S&P, in its December 2014 report on Fonterra.

Trading Among Farmers (TAF) and the Fonterra Shareholder Fund (FSF), which were 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.

TAF and FSF did two things: it removed the risk that Fonterra's balance sheet could be drained by having to buy back a large volume of farmers' shares (called "redemption risk"); and it improved "price discovery" of Fonterra's shares, although the volatile nature of FSF's share price since TAF was introduced raises questions about the price discovery objective.

Fonterra is now using capital to provide interest-free loans to its supplier-shareholders to help them through the low payout.

As a substitute for lack of capital, Fonterra used off-shore joint ventures to grow new business. However, it is not clear that the gains they deliver reflect fully the complexity, risks and costs that Fonterra incurs.

Capital into stainless steel

The fifth key factor contributing to Fonterra's apparent failure to move more of its business up the value chain is that the capital Fonterra does have has been channelled mainly into plant and equipment for processing raw milk in New Zealand, which dominates Fonterra's business.

Reflecting the infrastructure-intensive nature of Fonterra's operations, growth in capital expenditure has been greater than growth in selling and marketing expenses.

As Arie Dekker, Head of Institutional Research at First NZ Capital, highlights: "Fonterra is committed to continuing to grow milk supply in New Zealand and hold its significant market share. This still demands investment largely in stainless steel processing capacity focused on commodity powders. This driver is a real constraint on the pace with which Fonterra can realistically turn the wheel".

Alan Bollard, now Secretary General of APEC, alluded to this issue in a speech in Wellington earlier this year when he said: "There is something about the way returns between Fonterra and farmers go that isn't cycling into future capital expansion...you have to look at governance and incentives in the dairy industry."

Weak governance

Weak governance and limited capacity to execute are the sixth key factors contributing to the apparent failure to realise Fonterra's value-adding vision.

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 unavoidably and 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 Fonterra Shareholder Fund in place has improved things to some degree, but external monitoring of New Zealand's largest company is still substandard.

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.

Among many examples of deficient disclosure, Fonterra's current reporting does not enable its New Zealand processing business to be monitored on a standalone basis, which substantially weakens any measurement of its efficiency against the regulated farm gate milk price. Forecasting Fonterra's results has also been difficult due poor disclosure of underlying performance drivers and expected earnings.

Arie Dekker of First NZ Capital again: "A business with Fonterra's complexity, changing composition and volatility needs better disclosure to help avoid some of the surprises in earnings and help farmers and investors better understand where the underlying earnings of the business sit". This is certainly apposite given the dramatic down-turn over recent months.

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 last 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.

However, among supplier-shareholders, Fonterra's status as a co-operative controlled 100% 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 god-father, 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".

There is even a deep misconception that exclusive farmer-control is required to add value to New Zealand milk. Sir Dryden again: "if [Fonterra] ever ceased to be owned by farmers it would almost certainly have a different core purpose than that of adding value to New Zealand milk".

Fonterra's approach and options are heavily proscribed by these articles of faith 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% 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 cooperative membership.

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

Where to from here?

Despite its fundamental weaknesses, Fonterra's vision is still to earn more from higher value market segments. By 2025, it wants total sales to come 21% more from consumer and foodservices, 10% more from overseas partnerships, 15% less from ingredients and 6% less from the global dairy auction market.

If you keep saying something and use more seductive words and pictures, perhaps you can persuade yourself that a wish can become a reality. However, 14 years on, Fonterra is further away from its core goal than when it was formed.

Rather than dabble with indifferent results in so many parts of the value chain, Fonterra should concentrate on the things it is good at and dispense with the rest. This may mean paring back to commodities and related ingredients. It certainly means Fonterra turning itself into a very efficient low overhead machine.

Fonterra should also only purchase and process volumes of raw milk that make economic sense. To this end, Fonterra reduce its market share to below the statutory thresholds that require it to collect all raw milk where ever it is produced.

It should also put in place mechanisms to signal in on a regular basis the value of raw milk during the season. The value of Fonterra's processing should also be signalled separately from the price of raw milk.

Critical is Fonterra recognising its weaknesses and ceasing to do things that don't have a strong prospect of meeting sensible risk-adjusted rates of return. Fonterra and farmer-suppliers should be driven by profitability, not volumes and market share, and this should be supported by a higher standard of disclosure and performance monitoring.

If co-operative members want a financial stake in higher value dairy businesses, they can invest directly in successful international companies like Nestle, Danone, Abbott Lab and Mead Johnson. Better than farmer-shareholders' current compulsory down-stream investment through Fonterra, farmers would be able to choose if and when to invest, how much to put in, and manage when they want to change their exposure.

Finally, Fonterra should organise itself so it doesn't rely on special legislation to exist and operate. As the Australian Competition Review Panel found in 2014, issues concerning the creation of "national champions" can and should be addressed under normal competition laws.

Australians reject Fonterra model

It is interesting that the Australians last year roundly rejected the single integrated co-operative model. It was recommended by McKinsey & Co, key advisers and promoters in forming Fonterra.

The Australian Productivity Commission (ACP) completely dismissed the claim that a single dairy co-operative would give it market power to influence international prices – a myth that has dominated and constrained the New Zealand industry for so many decades.

Indeed, it was a key reason advanced for forming Fonterra. Founding chairman, John Roadley, boasted in 2003 that it "gives us market power [and by] having market power, Fonterra gives the farmers the only viable means by which they can move ever more of their milk towards the higher end of the value chain".

Australian authorities also condemned the idea that success overseas requires unity and non-competition in the domestic market. As the Australian Competition and Consumer Commission stressed in 2014: "if you cannot beat your rivals at home how can you hope to do so overseas?"

While the Australians have preserved effective competition at the farm-gate, New Zealand's industry leadership for decades has focused on eliminating it. Fonterra claiming that it's our "national champion" is equivalent to saying that we should have the All Blacks without the Super 15 and ITM rugby competitions.

The ACP also highlighted that the emergence of a dominant manufacturer is not a prerequisite for developing distinctive national branding for dairy products, that there are potential risks if the industry's overall performance is linked with one company, and that Fonterra-like arrangements are not necessary to ensure that scale benefits at the plant level are realised.

Most significantly, the ACP concluded that "it is overly simplistic in the Commission's view to put New Zealand's relative increase in dairy exports primarily down to the formation of Fonterra, let alone to use this experience to drive policy decisions in Australia".

Conclusion

In reality, Fonterra was not a "break-through idea". It did not "catch the knowledge wave". Raw milk is not "white gold" or "better than an oil well".

As Bill English told Parliament in 2001, forming Fonterra was, underneath the flannel, the "product of a political deal between the Government and the dairy industry". It was a defensive compromise to break an impasse. The industry agreed to lose the Dairy Board's statutory "single exporter" powers on condition that the government replaced it with special legislation enabling the formation of Fonterra. In short, the statutory monopsony was swapped for a commercial near-monopoly with special rules.

It was a paradoxical deal: the industry believed it would continue a highly dominant dairy exporter; deregulation supporters hoped it would lead to contestability and significant innovation. 14 years on, it looks like the industry was right.

Tony Baldwin

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