The New Zealand Herald

"Fonterra – The Experiment That Failed"

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Value destroyed

What's happening with Fonterra? Yet another year of awful headlines.

Underlying profit has fallen two years in a row for a combined $456 million loss[1]. Over half its $750 million investment in BeingMate, a Chinese infant nutrition company, has been written off[2]. More write-downs may follow.

Add this to the $200 million that Fonterra wiped-out in its previous Chinese infant nutrition investment[3]. Some other overseas assets are also likely to be in poor health.

To top it off, Fonterra last year had to pay $183 million in compensation for its botulism scare[4].

In short, Fonterra has destroyed a whole lot of value.

Not surprisingly, key players in the capital markets describe it as "a huge disappointment"[5] stressing that Fonterra "needs to show a strong outlook to regain confidence"[6].

Fonterra's diagnosis and action plan

Taking risks and incurring some failures is the essence of any business. Fonterra is not the first major New Zealand company to bomb in overseas investments. What counts is how well it learns and adapts.

So what's gone wrong? Fonterra puts it down to poor forecasting, high butter prices, a high of cost raw milk, and high operating expenses[7].

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[1] ASB analyst Nathan Penny - https://www.stuff.co.nz/business/farming/107027100/fonterra-loss-of-196m-its-first-ever-loss
[2] https://www.stuff.co.nz/business/farming/107382282/how-fonterra-sold-beingmate-to-shareholders--and-got-it-wrong
[3] https://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=10569769
[4] https://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=11951198
[5] Craigs Investment Partners head of private wealth research Mark Lister, Aug 2018
https://www.stuff.co.nz/business/farming/106162023/Fonterra-units-fall-to-three-year-low-following-downgraded-forecast
[6] John Shewan, Chairman, Fonterra Shareholders Fund, September 2018
http://www2.nzherald.co.nz/the-country/rural-business/news/article.cfm?c_id=1504329&objectid=12123932

Their plan to put it right? Move another long-standing director into the role of chairman, get a new CEO, promise better forecasting and stricter discipline around costs, and review asset performance[8].

Yet Fonterra's leadership still says: "Fundamentally, the strategy doesn't change"[9]. "The strategy in a nutshell is delivery"[10].

Voices at the margin have again raised the idea of separating their consumer business into a separate company controlled by Fonterra but allowing outside capital. However, it is clear that the centre of gravity of farmer opinion continues to strongly favour keeping Fonterra together as a vertically-integrated farmer-only co-operative, a model described by their new chairman as having "served us well for 18 years".[11]

The chair of Fonterra's Shareholders Council weighs in more strongly: "the co-operative has been around for 145 years in some form or another, which speaks volumes for the enduring nature of the co-operative model and the responsibility to ensure this remains for future generations".[12]

A change that Fonterra is pushing is to end its obligations to supply raw milk to competitors and accept milk from new farmer-shareholders. (More on that shortly).

In summary then, Fonterra's diagnosis is – right model, right strategy, poor execution. And we need to ease regulations that help competition.

Deeper failure

Stronger disciplines around costs and assets would certainly make a difference for Fonterra. Better execution would help too. But these are only partial fixes.

The deeper problem is that Fonterra has fundamentally failed to achieve the objectives for which it was established 17 years ago. Worse, it has failed to generate any real growth in value for its suppliers or shareholders.

In any other industry, creating a near-monopoly by special legislation would be rejected out of hand as contrary to basic norms on how to grow a country's wealth and improve productivity.

But Fonterra was given special treatment because it was going to achieve special things only possible as a near-monopoly – or, as Fonterra likes see itself, as New Zealand's "national champion" in world dairy.

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[7] https://view.publitas.com/fonterra/https-view-publitas-com-fonterra-fonterra-shareholders-fund-annual-report-2018/page/2-3
[8] https://view.publitas.com/fonterra/https-view-publitas-com-fonterra-fonterra-shareholders-fund-annual-report-2018/page/2-3
[9] Fonterra CFO Marc Rivers, Sept 2018 - https://www.newsroom.co.nz/2018/09/17/241094/is-it-time-to-carve-up-fonterra-and-sell-it
[10] Fonterra's acting CEO Miles Hurrell, Sept 2018 https://www.newsroom.co.nz/2018/09/17/241094/is-it-time-to-carve-up-fonterra-and-sell-it
[11] Fonterra chairman, John Monaghan, Aug 18 https://www.radionz.co.nz/news/business/364167/new-fonterra-chairman-says-no-doubt-of-strategy-change
[12] Fonterra Shareholders' Council chairman Duncan Coull, Sept 18 - https://www.stuff.co.nz/business/farming/dairy/96065289/fonterra--shareholders-council-working-for-its-farmers

Fonterra's formation was heralded as a key move in the country's economic transformation. "For too long New Zealand has been trying to sustain First World living standards on the back of Third World exports. That does not add up," Prime Minister Helen Clark told the Parliament in 2001.[13]

Instead of simply producing more dairy commodities, Fonterra was to generate a huge amount of new revenue from new products in pharmaceuticals, health food, and specialised ingredients. These new revenues were to rise to double the value of traditional commodity sales in a massive 10 year step-change.[14]

17 years down the track, did the special treatment deliver special results? Sadly, not. Mainly, Fonterra has continued on the industry's pre-existing trajectory of producing ever larger volumes of dairy commodities, especially whole milk powder which has more than doubled in production since 2001.

Instead of 15% revenue growth per year, it's achieved less than 2.5% per year over the last 17 years, as reported by TDB Advisory, who also calculate that its normalised earnings increased by just 0.6% year-on-year.[15]

Only four years ago, Fonterra forecast additional earnings of $15 billion within three years from its $750 million investment in BeingMate[16]. However, as First NZ Capital reports, there has been no growth in cashflows or earnings since 2012.[17]

Instead of growing shareholders' equity by $20 billion in its first 10 years, Fonterra has added just $3 billion over 17 years, and most of that came from farmers buying more Fonterra shares so they could supply more milk.[18]

Since 2012, shareholders' equity has been barely increased[19]. In the same period, net debt has increased 63%.[20]

In short, despite large investments by Fonterra, the only meaningful growth has been increased volumes of milk.

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[13] https://www.beehive.govt.nz/speech/prime-ministers-statement-parliament-part-1
[14] Dairy Industry leadership, Presentation to Select Committee, 27 July 1999, slides 55-57 http://tonybaldwin.co.nz/mainpages/publications/publicationsdairy.htm - with fundamentally the same strategy outlined by Fonterra in 2002 – see article in NZ Herald, 8 November 2002 – http://tonybaldwin.co.nz/publications/dairy%20publications/2002/tony/nz%20herald%20change%20%208%20nov%2002.pdf
[15] TDB Advisory, "Fonterra – A Long-Run Financial Assessment", 26 September 2018 - https://www.tdb.co.nz/wp-content/uploads/2018/09/TDB-Advisory-Fonterra-Long-Run-Financial-Assessment-Sept-18.pdf
[16] http://www.uabsknowledge.ac.nz/en/research-and-comment/research-and-analysis/fonterra-s-audacious-global-master-plan.html
[17] FNZC, Research Note, 13 September 2018, Figure 2, bottom of page 4
[18] Arie Dekker (FNZC), 2 September 2018 – "Market value of equity over FY02 to FY18 has increased from ~$4.9 bn to $8 bn with most of that coming from growth in the number of shares subscribed to by farmers as they shared up for growing milk supply. Book equity has increased from $4.5 bn to $6.3 bn – same point – its more shares subscribed for".
[19] FNZC, Research Note, 13 September 2018, Figure 2
[20] FNZC, Research Note, 13 September 2018, Figure 2

Underlying forces

The dominant force driving Fonterra has not been a strategy of transformation, but rather a seismic shift in land use.

Since 1990, nearly a million hectares of sheep and beef land has been converted to dairying[21], bringing with it nearly 2.5 million additional cows, with 20% more cows per hectare, and each cow now producing nearly 50% more milk on average.[22]

The result has been a tidal wave of extra milk, nearly all of which has to be exported.

Despite decades of strategy hype about "moving up the value chain", the reality is that Fonterra has been driven not by what consumers demand but rather by what its suppliers push.

Fonterra's crux role as a producer co-operative is to serve its supplier-shareholders. This imperative, which dwarfs the rest, requires Fonterra to pour large sums of scarce capital into new factories to process that white tidal wave. By default, most of the milk is turned into commodities, especially whole-milk powder.

While Fonterra likes to think of itself as also being a multinational marketing company and an international capital investor, at its core it is an extension of its members' farms — a club in which farmers jointly own plant to provide shared services that they can't afford individually.[23]

So how has the average Fonterra dairy farmer fared? The average price received for his or her milk has barely increased in real terms since Fonterra was formed 17 years ago[24]. Their shares in Fonterra are worth only 28% more than in 2001[25], while over the same period the NZX50 index (and predecessors) has increased by more than 400%.[26]

Over the last 10 years, while production on the average farm increased by 40%, term borrowings have nearly doubled. Annual return on assets has averaged just 5.7% (this includes changes in capital value, which averaged 1.4% per year). Over the same 10 year period, average return on equity for the average farmer was just 5.6% (which includes changes in capital value).[27]

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[21] AgFirst,"Analysis of Drivers and Barriers to Land Use Change", August 2018, Table 1 at page 9 and Figure 2 at page 10

[22] LIC, DairyNZ, "New Zealand Dairy Statistics 2016-17", Tables 2.1 and 2.2

[23] US Department of Agriculture, "The Nature of the Cooperative A Dairy Cooperative Case Study", Research Report 224 at page 17 - http://www.uwcc.wisc.edu/pdf/Nature%20of%20coop%20dairy%20case%20study.pdf: "A cooperative does not own the assets that are employed by members for farm production; the assets and the investment hazard associated with asset specificity belong to member-farms. By pooling members' products in its marketing efforts, the cooperative in essence also pools the investment hazard. As a result, each member's share of the hazard conceivably is less than if the member individually markets his or her products. The fact that asset specificity and the associated investment hazard belong to individual members reaffirms the cooperative's unique economic structure of being an aggregate of its member-farms. As posited by Emelianoff, this unique economic structure entails its uniqueness in organization, governance, equity financing and operation—and unique economics of operation for marketing cooperatives".

[24] FNZC, Research Note, 5 Feb 2018: "Taking inflation adjusted milk prices (Figure 4) from just prior to FSF's formation to 2018 highlights very limited improvement in the total payout received by New Zealand farmers over the last 20 years"

[25] On formation, Fonterra's fair value share price was set at $3.85. Expressed in 2018 dollars (using the Reserve Bank's inflation calculator), this is $5.47 at 2018Q2. So in real terms, Fonterra's share price has decreased by $0.55 or 11%

[26] Aire Dekker, email of 3 Oct 18: "NZX50 (and predecessors) up over 400% since 2001"

[27] All references in this paragraph sourced from Dairy NZ, "Economic Survey 2016-17" at pages 57 and 8, Tables 7.6 and 7.7 – uploaded to my spreadsheet "Historical data"

Put simply, the return delivered by Fonterra on the special treatment it received from Parliament has been less than ordinary.

For the environment, the costs have yet to be fully counted or compensated.

Crux problem

The crux problem remains the same as when Fonterra was formed 17 years ago – namely, the serious mismatch between Fonterra's aspirations and strategy (on the one hand) and its capability, resources and shareholders' structural requirements (on the other).

It aspires to be an innovative, agile, consumer-driven business with access to large amounts of capital to fund higher margin products and brands in higher value markets around the world, and to invest in complimentary businesses.

But it can only do this from a producer-driven, capital constrained, relatively inflexible platform bounded by deeply entrenched requirements from farmers in relation to structure – namely, a farmer-only cooperative, with no outside share capital, paying out most of its earnings, processing all members' milk, with a single national milk price set at the end of the season, with nationally averaged collection costs[28], operating as a near-monopoly within New Zealand.

In short, it's an oxymoron – a tangled knot of contradictions and wishful thinking. Like a weightlifter pretending that he or she can be a great pole-vaulter.

This is not (and never has been) an anti-cooperative stance. Dairy co-operatives are well adapted to certain purposes. With their focus on shifting large volumes of milk for supplier-shareholders, they tend to dominate milk collection and dairy commodity markets around the world. However, when products become highly differentiated and performance centres on capital rather than members' milk, dairy cooperatives are less well adapted.

Their difficulties in retaining funds (paying out too much to members), and in finding a structure that allows innovation and access to outside capital, have been well known among experts for many years[29]. Back in 1999, Bengt Holmstrom[30], co-winner of the 2016 Nobel Prize in economics, observed that co-operatives are "disadvantaged in the innovation race".

What to do?

The simple answer is for Fonterra to adjust its aspirations and strategy to properly reflect its capability, structure and resources, or visa-versa, or both.

Common to all options is the need for Fonterra and its suppliers to be driven by profitability, not volume, with a higher standard of disclosure and performance monitoring.

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[28] Confirmed by Prof Keith Woodford, 3 October 2018

[29] Most recently by Rabobank - https://www.rabobank.com/en/press/search/2018/20180726-global-dairy-top-20-a-shuffling-of-the-deck-chairs.html and https://www.stuff.co.nz/business/farming/107011027/kiwi-execs-turn-down-chance-to-head-fonterra-and-earn-5m-a-year

[30] Prof Bengt Holmstrom, Samuelson Professor of Economics, Massachusetts Institute of Technology - https://economics.mit.edu/faculty/bengt - "Future of Cooperatives: A Corporate Perspective", TA 4/99, at 415 - http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.454.3393&rep=rep1&type=pdf

The key options include:

1. **Better execution of current strategy** – Continue with the current structure and scope of business, but put in place internal measures to make forecasting more accurate, discard or rectify poorly performing investments, improve disciplines around decision-making and monitoring, and somehow do better at executing the current strategy.

2. **Trim to the core and simplify** – Keep the things Fonterra is good at and trim the rest. The resulting core must then become a very efficient low overhead machine, simplified around commodities and certain ingredients made from New Zealand milk, with a focus on delivering proper returns on investment.

   Keep in mind that large volumes are not essential to do commodities well. TDB Advisory analysis indicates that Open Country Dairy, a mainly commodity processor with just 7% of the market, is well ahead of Fonterra in cost efficiency[31]. The Australian Productivity Commission has highlighted that the benefits of size and scale are not necessarily greater than its costs.[32]

   Other improvements under this option include much better milk price signals, a variety of risk management options for suppliers, separating returns on processing from the milk price, more flexibility for farmers on how many shares they have to hold relative to milk volume supplied, strengthening Fonterra's the balance sheet, and creating a proper wholesale milk market.

3. **Separate company for non-core business** – Parcel up the non-core parts of Fonterra (which includes the higher risk, capital-thirsty consumer business) into a separate company controlled by Fonterra with access to non-farmer equity. Farmers could choose whether to hold shares or instead put their capital into other assets.

   At present, farmers have no choice on whether their Fonterra capital is invested outside the core, which make it relatively "soft" money for Fonterra. This structure was proposed 20 years ago by industry leaders who were, in effect, overthrown.

4. **Split into two or more cooperatives** – Given farmers' aversion to outsiders, an alternative would be to split Fonterra into two or more separate cooperatives owned by New Zealand dairy farmers. Most of the special rules and regulations now in place to guard against Fonterra's highly dominant position in New Zealand would cease. A proper wholesale milk market among competitors could be fostered.

   After an extended transitional period of sharing brands and various services, each cooperative would become independent of the other free to purse separate strategies and growth structures. As economist Tim Harford highlights, adapting to a complex changeable world is best achieved by a multiplicity of experiments from many different players.

[31] TDB Advisory, "New Zealand Dairy Companies Review", April 2018, Figure 14 at page 18.
[32] Australian Productivity Commission, "Relative Costs of Doing Business in Australia: Dairy Product Manufacturing", Research Report, September 2014 at pages 7 and 8 and others.

5. **List on the stock exchange** – If the preference is to not separate Fonterra's core from its non-core businesses, but to still bring in more capital, flexibility and external monitoring, another alternative would be to turn Fonterra into a public company where the controlling stake is held by dairy farmers (through a cooperative) with the balance of shares sold to the public. This concept was proposed by Fonterra's board in 2007 but rejected by dairy farmers.

   Kerry PLC in Ireland is often cited as a model. On listing in 1986, the diary cooperative's 51% stake was worth €40 million[33]. Today, its holding (now around 14%) is worth around €2,300 million[34] – and the cooperative is still the largest shareholder by far[35]. (In listed companies with widely held shares, effective control is achieved well below 51%).

   Kerry PLC is now a diversified multinational food business. Its change in trajectory from traditional dairy cooperative was triggered by a bovine disease crisis and a major philosophical re-think.

No such re-thinking on planet Fonterra. Despite its fundamental non-performance, Fonterra's preferred option is still largely the current structure and strategy "with better execution" (option 1 above), plus a relaxation of Government rules designed to counter Fonterra's high market dominance in New Zealand.

Relaxation of pro-competition rules

In particular, Fonterra wants an end to the rules that allow any farmer to become a member of Fonterra and supply milk, and also to end (or at least soften) the rules that require Fonterra to supply certain amounts of milk to competitors.

Fonterra has argued that the open entry and exit rules drive it down the commodities path. In 2016, the Commerce Commission rejected this claim finding that Fonterra's volume push comes not from the rules, but from two drivers of Fonterra's own making: its incentives to maintain and grow its cooperative base[36]; and its strategy for rapid and large growth in milk volumes[37]. In 2016, Fonterra's strategy called for an additional 8 billion litres of New Zealand milk (about a 38 per cent increase).

Fonterra is also concerned about its loss of market share. Since it began, Fonterra's share of the national raw milk market has fallen by 14%[38], even though the total milk production in New Zealand has increased by 61% in the same period.[39]

Indeed, Fonterra has had no material growth in milk supply from New Zealand over the last six years[40], yet it still aspires to significantly grow its volume, even though New Zealand production has flattened.

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[33] http://tonybaldwin.co.nz/mainpages/publications/publicationsdairy.htm - see 2016 - "Structural options for cooperatives" at slide 12
[34] At 4 October 2018, Kerry PLC's market capitalisation was €16.642 with a share price of €94.40 - https://www.bloomberg.com/quote/KYG:ID - of which the Kerry Cooperative holds 13.7%%.
[35] In Kerry PLC, there are only three shareholders with holdings above 3% - Kerry Cooperative at 14% and another two at around 5% and 3% respectively – see their 2017 Annual Report at page 75 - https://www.kerrygroup.com/investors/results-presentations/
[36] Commerce Commission, "Review of the state of competition in the New Zealand Dairy Industry", March 2016 at 5.107, 6.12 - https://comcom.govt.nz/regulated-industries/dairy/projects/report-on-the-state-of-competition-in-the-new-zealand-dairy-industry?target=documents&root=88358
[37] Commerce Commission, "Review of the state of competition in the New Zealand Dairy Industry", March 2016 at 6.15 – 6.17
[38] TDB Advisory, "New Zealand Dairy Companies Review", April 2018 at page 6
[39] LIC, DairyNZ, "New Zealand Dairy Statistics 2016-17", Tables 2.1 and 2.2 – uploaded to my spreadsheet "Historical Data"

As our “national champion” in world dairy markets, Fonterra expects to remain highly dominant in New Zealand, so it wants the Government to change the rules to make it harder for farmers to switch and harder for competitors to grow. That would be a mistake. The right response would be for Fonterra to deliver better performance so that farmers prefer to supply Fonterra over its competitors.

Who decides?

There are two decision-makers. How Fonterra runs its business is for its 10,000 farmer-shareholders to decide.

However, the regulatory constraints within which Fonterra operates are for the Government to decide. Not surprisingly, the interface between the two is blurred in politics.

Fonterra is poorly adapted to its purpose. It is time for its members and Government to shed deeply ingrained beliefs and look at things with a more open mind.

Fonterra did not achieve “critical mass” to take on the big players in higher value markets. Overseas prices would not be lower with competing exporters from New Zealand. Investor-owned dairy companies have not (now or in New Zealand’s history) exploited dairy farmers (quite the opposite, in fact). Effective control does not require 100% ownership.

Based on 17 years of evidence, it is objectively fair to say that, in its current form, the Fonterra experiment has failed. The gradual emergence of a few relatively small competitors is of course a positive, but Fonterra’s legislated dominance continues more than 100 years of suppressing diversity and experimentation in how to best capture value beyond the farm gate, to the significant cost of the New Zealand economy.

If keeping cooperatives is key, option 4 should be considered with an open mind.

For further information on alternative structures, key issues and how history is constraining Fonterra’s future, go to –
www.tonybaldwin.co.nz/mainpages/publications/publicationsdairy.htm

[40] FNZC, Research Report, 23 July 2018, Figure 2 on page 3