



**NEW ZEALAND NUFFIELD  
SCHOLARSHIP 2007**

***Adding Value to New Zealand Milk***

By Les Keeper



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For as long as I can remember, the catch cry of New Zealand agricultural producers has been to “add value”. Governments and business circles have pointed the stick at the agricultural sector demanding we step up and add value to our commodity products by further processing and marketing before we on-sell that produce.

Dairy companies and Dairy Boards have invested in brands and marketing campaigns to establish a dominant market share in consumer products. The superior value from the consumer markets would add to the returns and enhance the value New Zealand dairy farmers would receive for their milk. Of even greater importance was the added value from consumer markets, which would come into their own in times of low commodity prices. The higher returns from the consumer markets would bolster the ailing commodity prices and provide stability against the rollercoaster nature of commodity returns.

The cost of developing and competing for, a dominant market share in the consumer sector, proved to be very high, with an extremely long payback period. The swings in global commodity pricing and the influence of a floating New Zealand dollar when adverse to New Zealand milk returns have not been able to be offset by the returns from the consumer markets.

The struggling returns from the consumer markets presented a dilemma in times of good commodity prices. Too many times, product and commitment were withdrawn from the consumer markets, to chase the spiking commodity prices. Add to this the recent massive increase in the production of raw milk in New Zealand and the role of adding value to New Zealand milk through consumer products becomes even more daunting.

### **Can New Zealand dairy companies dominate global consumer markets?**

Not to be dominant, is to fail. The cost of competing with other global consumer players and then having to fight with the global supermarkets for shelf space and a premium above their house brands, is intense in every respect. To quote Ireland's Barry Brennan of Glanbia PLC:

*“When we went to the market in '88, the funding was targeted at geographic expansion of our milk pools with the key objectives of maximising shareholder value, considering the EU quota regime, etc.*

*We spilled serious money along the way until we realised we really were too late to build a consumer business even regionally. Very few have managed the full value chain and I'm not convinced you need to be in all products, all sectors and all geographies."*

It is worth noting, that Nestle has divested their manufacturing capabilities and tightened the focus on their brands. To the point where consumer products become commoditised by competitors and supermarkets, Nestle is looking to divest their less profitable consumer brands. Who would have ever envisaged Nestle looking to divest from the condensed milk market?

### **Is New Zealand a world leader in consumer brands?**

Throughout our dairy history, the consumer business has not been a particularly happy place for New Zealand.

- **UK**

If we take a flight around the globe and start with the UK, we see a long history of deteriorating profits and increasing losses with the Anchor brand marketing NZ's butter quota. Today New Zealand has basically exited the UK market. Arla, the Danish dairy co-operative, markets our butter. New Zealand is a silent partner and the company is performing exceedingly well.

- **Europe & USA**

NZ has no consumer presence here. Well established players and brands dominate these markets and tariffs and trade barriers in place make entry difficult.

- **South America**

Consumer positions traded to Nestle in exchange for manufacturing plants.

- **Asia**

Asia is the most successful region with milk powder products dominating. It's a history marred by long rollouts and erratic performance.

- **Australasia**

A lot of money has been invested with poor payback to date. Drought and the over capacity of manufacturing plant are thought to be factors contributing to poor results. Acquisitions of assets, such as National Foods in Australia and Dairy Foods in New Zealand, put the spotlight on New Zealand dairy companies understanding of the value of the consumer business and the capabilities of their own companies.

In recent visits to Australia, I observed Anlene speciality liquid milk being marketed in NSW at a discount against ordinary blue and green top milk. This, in a market place where the New Zealand company in question, does not have good liquid milk distribution infrastructure. This is a worry. In other parts of the globe it was the supermarkets lowering the value of milk in consumers shopping trolleys, not dairy companies.

### **How about New Zealand being a regional consumer player?**

Historically, successful dairy companies in the consumer business tended to start out as consumer businesses. Companies like Arla, Friesland, Campina and Glanbia had strong market share in their local consumer markets, with surplus milk being directed towards manufacturing. The weighting of resources and strategy typically focused on their consumer business.

Consumer and commodity/ingredients businesses are like chalk and cheese. To be a commodity/ingredients company with a small regional consumer business is a big ask, with major clashes in many of the business disciplines and values. Fonterra's consumer business to date has been on a regional platform and has struggled to achieve returns above the cost of capital. When a company is a global operator, small regional plays often struggle to provide sufficient scale to warrant a company's involvement. That is not to say it can't be done, but it does take great discipline.

In the future, NZ consumer players will have to start displaying maturity and discipline to limit themselves to their successes. For example, Fonterra has a very successful consumer business in Sri Lanka. If egos and ambitions are allowed to get in the way, it will destroy our consumer business.

It appears that the 'sexy' image of the consumer business has, and continues to, transfix and mesmerise our dairy leaders, consultants and institutions.

**To look forward it is important to first look back to where we have come from.**

The New Zealand Dairy Scene:

1814	Missionary Samuel Marsden brings a bull and two heifers to New Zealand
1845	Consignment of cheese shipped from Banks Peninsula to Sydney, becoming New Zealand's first dairy export
1871	New Zealand's first co-operative cheese company is formed on Otago Peninsula
1882	'Dunedin' sails for London from Port Chalmers with the first refrigerated shipment of beef and butter
1883	First cream separator is installed in milk shed. Home separation of skim milk from cream becomes possible
1886	Henry Reynolds opens butter factory at Pukekuro in the Waikato. Anchor brand born.
1923	Government establishes Dairy Export Produce Control Board, the first dairy board, to control all dairy exports
1927	Amalgamated Dairies is established in London by a number of New Zealand dairy companies to market New Zealand butter and cheese in the United Kingdom
1930	New Zealand has more than 400 dairy cooperatives
1947	Dairy Products Marketing Commission is established giving industry and government shared responsibility for export marketing
1951	Whole milk collection by tankers begins
1955	Ice bank cooling of milk in farms introduced
1961	Dairy production and marketing board established an amalgamation of the Dairy Products Marketing Commission and the Dairy Board. The Board establishes first overseas milk recombining plant in Singapore.
1964	Introduction of direct expansion refrigeration for milk cooling on farms. Dairy herd reaches two million on farms.
1973	Britain enters EEC (now EU) and the market diversification drive becomes urgent
1978	Gatt multi-lateral trade round begins with agriculture on the agenda for the first time
1980	Whey Products New Zealand established to drive manufacture and marketing of whey, previously a waste product. Dairy Boards global marketing network grown from 19 subsidiaries and associated companies in 1980 to 40 by 1990 (and 80 by 1995). Dairy Board establishes standard cost models in 1987 reflecting manufacturing costs for products, triggering a cost reduction drive. Government removes farming subsidies.
1994	Industry Efficiency Improvement Study. Industry committee established calls for rationalisation of 15 cooperatives and initiates Business Development Project

1996	Dairy Board Amendment Act transfers ownership of the Board's US\$1.26b assets to Dairy Cooperatives
1997	Industry rationalisation gains momentum – 12 co-operatives exist
1998	Dairy Board brings in commercial pricing model. Government signals potential for industry deregulation. Industry rationalisation continues.
2000	Industry chooses one single mega company as best structural option to implement its strategic plan
2001	Farmers vote to form new company – later named Fonterra Dairy Co-operative Group
2007	The players are: Fonterra Westland Tatua Open Cheese Co New Zealand Dairy Synlait Dairy Trust plus a number of small boutique and local market operators

### Fonterra

The largest farmer owned dairy co-operative. Processes upwards of 95% of New Zealand's milk. Globally Fonterra is responsible for the trade of 40% of the world's dairy product sold across borders.

### Westland

Despite a very challenging geographic and climatic environment, Westland has performed to a very high level. With their fixed nominal share price at a very low industry level, this co-operative has grown its business while maintaining a very competitive performance. They have the advantage of being able to 'spot price' on the global market, whereas Fonterra with 40% of the world's traded milk operates with a greater level of production contracted.

### Tatua

Historically the highest performing dairy co-operative, Tatua specialises in proteins and innovation. Currently the high prices being recorded for milk powders globally, has placed Tatua at a competitive disadvantage. Tatua has to be able to roll out new products on a regular basis to earn premiums to offset its small scale and specialised product mix. Tatua's milk supply is fixed on a quota system and does not readily provide opportunities for shareholders to grow their business.

## Private Equity Companies

Private equity companies are a recent introduction to the New Zealand dairy processing scene. The environment for private equity has been opened up by the partial deregulation of the New Zealand dairy industry. These companies are opportunists and will be very focussed on their business. Their first challenge is to source milk supply. With most farmers supplying Fonterra, Fonterra becomes the natural target from which to lure suppliers. They have to convince farmers that in supplying them, they will be no worse off than staying with Fonterra. The carrot for farmers is that they can redeem their Fonterra shares and do not have to re-invest to supply the new company. Farmers must value Fonterra's ability and commitment to always pick up their milk and allowing farmers to increase production without quotas. The private equity companies, although small scale, will surprisingly keep Fonterra on its toes.

**Today the model that gives a clear market advantage over competitors has been dramatically redesigned by globalisation.**

Somewhere during my travels, I was told about an order of Zen monks or some such, who lived high up the slopes of an Oriental mountain. They had a little café there, and when climbers would step in, they would sell them coffee. There were two prices: a two dollar cup of coffee – and a two *hundred* dollar cup of coffee. When asked the difference, the monks would smile and say “A hundred and ninety-eight dollars.” The brew, the water, the cups, all were exactly the same, but there were always those who were willing to spring for the more expensive cup. They swore it tasted better.

Today it is relationships, service and synergies that are key to providing competitive advantage.

John Shaskey, formally head of Fonterra Ingredients business, impressed on me the value we can add to New Zealand milk through simply adding value to commodity milk as it passes through our supply chain.

Base milk	returns	commodity price
Speciality ingredients	returns	premium 10% to 30% above commodity returns
Highly specialised ingredients	returns	premium greater than 30% with some returns achieving 50% +

Enriching these products with a global supply chain and trusted relationships has the ability in itself to lift returns to added value status, fully utilising what we in New Zealand are good at.

Across the globe I met with customers and competitors of the New Zealand dairy industry. I explained with pride, that New Zealand dairy companies are highly specialised global food solution providers.

*Without exception, they sat me down and patiently explained that New Zealand dairy companies are not highly specialised global food solution providers. We are instead, simply traders of milk products. They did add that we are very good at trading milk.*

New Zealand does not register on the ingredients radar.

*New Zealand's neglect to invest and grow in the global dairy ingredients business is a black mark on past and current dairy leaders.*

During my research in New Zealand I was told too many times, that the ingredients businesses available for sale around the globe, were too expensive to buy. At these sale prices they said, we could not make a profit. This reoccurring message emphasised to me that the problem lies with our performance and capabilities, not the sale prices. We need to stop whimpering.

Over the last ten to fifteen years, European and American companies have invested heavily in research and product development with great success. Companies like Kerry of Ireland have taken advantage of this period and through acquisitions and internal capability have established themselves as world leaders in the ingredients business.

As James J. Kennelly, author of *The Kerry Way* (The History of Kerry Group, 1972 – 2000) writes... 'Dennis Brosnan CEO of Kerry Group had been dazzled by the size, scope, diversity and dynamism of the food markets in the US. He was particularly struck by the emergence of the "food ingredients industry". Convenience foods of all descriptions were burgeoning as the American market for fast and convenient prepared foods took off. What was particularly interesting to Brosnan was the type of ingredients used in these foods – highly specialised, engineered, and product- and customer- specific ones that offered high margins with large, quality customers in rapidly growing markets. Although many, but not all, of the ingredients were based upon primary foods like dairy foods, it was categorically *not* a dairy industry. The products developed were the result of significant research and development efforts and were targeted at specific applications of specific customers. In this way, it was possible to 'lock in' particular specialised ingredients into product formulations.



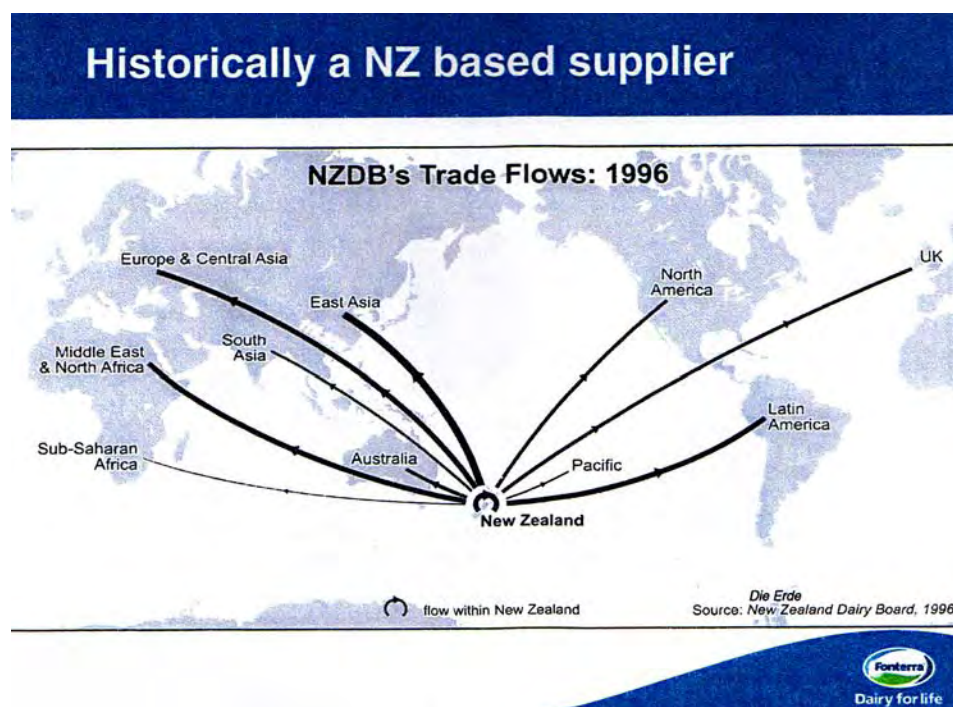
Given the high cost to customers of switching suppliers, this made for very stable demand and long term supplier-customer relationships. It was nearly a mirror opposite of a commodity industry – *a substantial and growing, highly technical, value-added industry*. This is where Kerry wanted to be.'

Today the large food companies like Nestle and Kraft are crying out for the 'next generation' in food technology. The demand for this has grown and further developed the highly specialised ingredient sector. Opportunities include *enzymes, fat replacements, vitamins, flavours, colours, cultures, bio-activities, antioxidants* and provide great opportunities to establish strong returns for food solution providers.

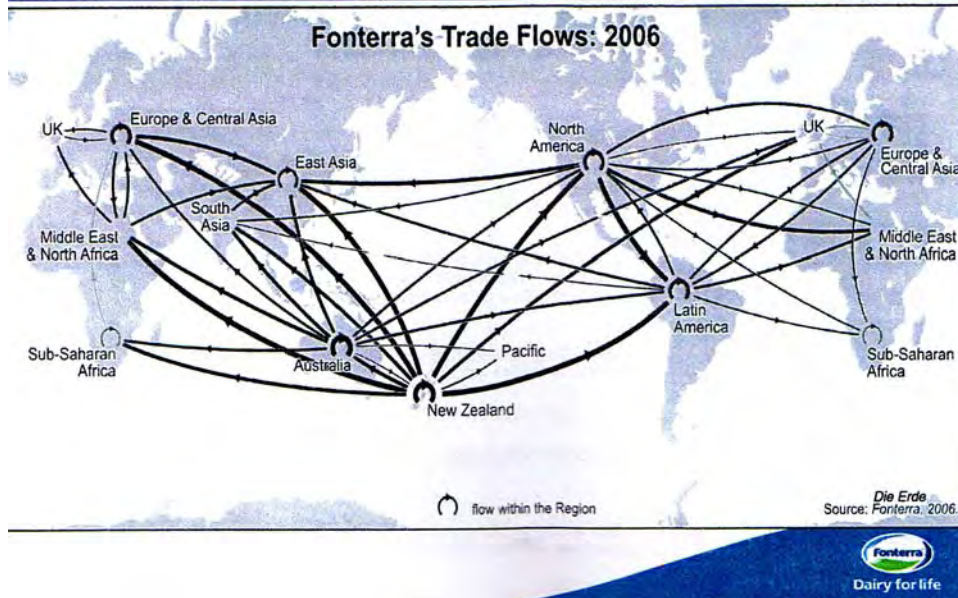
The global ingredient business allows New Zealand companies to operate behind borders without being unwelcome. For example, a New Zealand owned ingredients company can operate in Europe, acquire and further process European milk for European consumption.

As the largest New Zealand dairy company, Fonterra has a recognised and highly valued global supply chain. Today 25% of milk traded globally by Fonterra is sourced offshore, outside New Zealand borders. Fonterra is a contract supplier to the largest food companies in the world. Of the New Zealand dairy processors, Fonterra is the only processor that has the scale and global reach to make the transformation from a dairy trader to a food solution provider on a global scale.

Map of Fonterra global trading 1996 to 2006



## Volume growth now depends on MOPS



(MOPS - multiple origin product sourcing)

### Global agriculture itself is changing.

#### **Farmers' pockets reaping drought's bitter harvest as food prices rise.**

Asa Wahlquist, Rural writer | October 27, 2007

FOOD prices are up and will climb further, not just because of drought, but because primary producers have finally begun regaining the pricing power they lost more than 40 years ago.

For instance, vegetable prices have risen 21.5 per cent over the last year, according to this week's Consumer Price Index, and bread is up by 7.9 per cent. The same day the Australian Bureau of Statistics reported this bit of agflationary news, AWB announced it would be paying its highest ever price for wheat, \$395 a tonne, for the benchmark APW for the 2007-08 season, up 66 per cent on the cost of the flour in today's bread.

Grain is also a significant cost in chicken, egg, pork and milk production and some beef production.

Futuris Corp chief executive Les Wozniczka told his company's AGM on Tuesday: "Prepare yourself for some serious inflation in your cost of living because globally we are seeing pricing power starting to return to farmers.

"Unless recovery of input costs comes through in higher prices, farmers are increasingly either refusing to produce or converting to alternative products such as ethanol and biofuel."

Australian Farm Institute executive director Mick Keogh says these price rises are not just a brief blip due to drought or biofuels. He argues the fundamentals of farming and food production are changing.

The cost-price squeeze that has held farmers in its pincer grip since the late 1960s, forcing farmers' terms of trade relentlessly downward, is no more. "Since 2001-02, the trend has been the other way," Keogh says.

The costs which burdened farmers -- inflation, wage costs, labour and interest rates -- have not been increasing so quickly this decade, "so a lift in prices, which is what we have seen, has resulted in a turnaround in the farmers' terms-of-trade index". The late 60's and the 70's were the era of the green revolution and a massive increase in agricultural productivity. "The total volume of food available over that period -- per person -- increased by 30 per cent, so in many respects it was a simple supply and demand situation," Keogh says.

In the US, the EU and Japan, farmers were paid huge subsidies to produce food, resulting in huge surpluses -- the wine lakes and butter mountains. But in Australia, Keogh says, "to stay profitable, farmers were constantly on a productivity scramble where they had to increase their outputs per unit of input just to keep level".

But three things have changed this century. First, the subsidies paid to North American and European farmers have been decoupled from production. "The oversupplies and stockpiles have become a thing of the past," Keogh says.

The second is the growing wealth in developing nations like China and India. Consumers are moving from three meals of rice a day to eating a more varied diet which includes fruit and vegetables and animal protein.

Keogh says that to produce one kilogram of chicken, it must be fed about two kilos of grain, while grain-fed beef needs six kilos of grain

per kilo of beef.

"Basically, a kilo of animal protein uses between two and six times the same volume of grain to produce, so suddenly the demand for animal protein has the washback of escalating demand for feed grains in particular."

The third factor has been the more recent diversion of agricultural output into biofuels in Europe and North America.

There are two emerging pressures: the land available for agriculture is becoming constrained; and climate change.

In the US and the EU, more than 30 million hectares have been set aside for conservation.

In China, urbanisation is shrinking the available arable land. In Australia, the question is beginning to be asked whether this long dry is a drought that will break or whether it is a harbinger of climate change.

Keogh argues the result is "a quite different outlook in terms of real agricultural commodity prices to what has been the case for the last 40 to 50 years".

Vice-president of the National Farmers Federation, cattle farmer Charles Burke, is not so optimistic. "The reality is there is probably a couple of grain commodities where the international price has gone up, but in most cases most of them have not."

Burke points out the high Australian dollar is reducing the prices paid to farmers. And he is frustrated by the widespread assumption that high drought prices are flowing back to the farm gate and farmers' pockets. He cites several examples of commodities "where the farm gate prices have gone down and yet the wholesale price of that commodity has gone up. Beef, that is a prime example, some fresh vegetable and fruit lines. Milk, while the cents per litre has improved a little bit to the farmer, that is severely offset by the huge cost they have to bear at the moment by sourcing fodder".

He worries about the combined effects of drought, a high dollar and rising interest rates coupled with inflation. "This is uncharted territory," Burke says.

Two years ago vegetable growers, angered by the cancellation of contracts for Australian potatoes in favour of cheaper imported produce, drove on Canberra in their tractors.

But drought has changed the tenor of the times.

Tasmanian grower Mike Badcock is the president of the grower body Ausveg. He says a lot of growers are without water.

"There will be shortages. We will get a lot of fluctuating prices, at least for the next six months and probably longer if we don't get any substantial rain."

He thinks supplies of green leafy vegetables -- broccoli, cauliflower, cabbage and lettuce -- will go through periods of short supply. Historically, Australian vegetable growers have overproduced.

But drought has resulted in an undersupply. Badcock, who has just returned from a conference in Houston, Texas, says: "There is a world shortage developing. This extreme weather we are having in Australia is affecting most of the rest of the world. The EU and England are very worried about supplies."

Badcock says the drought has been a big wake-up call. But he sees some great opportunities ahead. "I do believe we are going to see some interesting times over the next two years."

No other dairy exporting country has a supply base like New Zealand, where one processor has such a large dominant share of the milk supply.

Fonterra is a 100% farmer owned co-operative that pays all profits from the co-operative activities back to the farmer owners, by way of a milk price paid out on farm milk production. The additional profit from quota income (UK market) and the additional 25% non-New Zealand milk of Fonterra's milk trade, is also added on to dairy farmers' on-farm milk production.

Add to this equation, the very small consumption of local consumers (approximately 4% of production) and it becomes difficult to accurately price the value of milk in New Zealand at the farm gate.

Each of the dairy co-operatives has a different share value farmers have to pay to supply. Since the deregulation of the Dairy Board, several private equity processing companies have emerged. These companies pay a price for milk without a requirement for suppliers to own shares.

## **How do we know then, if we are adding value to milk?**

Fonterra has a 'fair value' share where the share is recalculated each year, to fairly represent the value of the company's assets and the ongoing income potential of the company.

Since Fonterra's formation, the company's profit and payout has failed to match the return needed to support their share price.

Two issues are evident:

- 1) Despite the additional earnings from quota income and non-New Zealand milk, Fonterra's company performance has struggled to compete with the small processors. On a measure of payout per kilogram of milk solids, Fonterra has not consistently matched the smaller New Zealand co-operatives.
- 2) Fonterra has introduced an internal cost model to isolate the cost of milk, (the commodity milk price). This in turn helps identify the additional value they are able to add. This added value is the dividend earned from the extra capital farmers have invested, to further process and market milk above commodity returns. Unfortunately, since Fonterra's formation, the extra value the company has earned from its activities has not matched the expectations of the independent valuer and the share price.

There are two reasons for this:

- 1) Poor company performance, below that of its other NZ competitors.
- 2) Fonterra's strategy. Fonterra has set a strategy of producing and marketing fresh products to consumers behind borders. It is doing this by buying dairy farms behind borders, acquiring local milk and establishing distribution networks to market liquid milk and other fresh products. Along with the Australian business, this consumer strategy is very capital intensive and the payback is over a longer term, delivering a lower annual dividend yield. Fonterra has not been able to improve performance to match the independent valuer's expectation. If they wish to match their dividend yield to a specific share price, they have to invest in a strategy with a shorter payback time.

The smaller processors in New Zealand have strategies more aligned to commodity and ingredient businesses. This appears to be rewarding them with superior performance.

## **The real value of New Zealand milk to New Zealand's dairy farmers.**

Several factors make New Zealand's milk processing environment unique in the world and unique in representing value to the owners of the business.

- Only 5% of milk produced in the country is consumed domestically.
- The milk exported from NZ represents 40% of all milk traded around the globe, across borders.
- NZ's access to the most lucrative global markets is limited by quotas and tariffs.
- Fonterra's very large share of the milk supply and current government legislation makes it very difficult for other large milk processors to establish in New Zealand. The absence of large competitive milk processors in New Zealand allows Fonterra farmers to receive a higher farm gate price for their milk than would otherwise be the case.
- The co-operative model, while at times frustrating, does ensure all the returns are paid to the farmer. There is no siphoning or leakage. It is a simple matter of ensuring the company is performing.
- Debate surrounding cost models and where costs belong, is almost always political. Management should have internal mechanisms in place to confirm they are performing at the top of their game.
- The co-operative model where supply has to be matched by shareholding, ensures all the value of the supply chain and business is captured by the owners of the business. Currently, on an equity basis, whether Fonterra has the share price quite right or not is not too serious an issue for the owners of the assets. All of Fonterra's assets, including the value of the share price, are fully captured in farm land prices.

*Farmers do need to understand, that the large share Fonterra has of the New Zealand milk supply, is currently the single greatest added value component of their milk.*

Graeme Hart of Rank Group was at pains to impress upon me, the risk of changing the current environment. Any change that increases the potential for large outside milk processors to enter our local market, would destroy a lot of farmers' value. He warned that they would offer a good milk price for two or three seasons and then



watch farmers squirm without a contract. Good advice. We have seen this happen to agricultural and other sectors both here in New Zealand and overseas.

*The value that would be lost to farmers through lower farm gate prices for milk would be far greater than any value we can add through our value added endeavours.*

### **Co-operative or PLC (Public Listed Company)?**

The advice I was given was to be one or the other. There is no living in the middle.

Co-operatives use shareholders' assets as their capital and bank. Co-operatives are not answerable to the disciplines of global capital and behave altogether differently. They are not subject to the mood of the markets or vulnerable to share market attacks.

PLC's have to please all shareholders all the time and do whatever is necessary to derive a dividend, to keep shareholders 'on side'. We can all site an example where a poorly performing PLC has covered up poor performance only to dig a deeper hole that they then failed to escape from. There are no second chances.

A co-operative PLC hybrid has the headache of serving two masters. This problem can be further exaggerated in the agricultural commodity sector with commodity prices and exchange rates being so vulnerable to volatility. In the dairy world, tensions have built between the prices paid for farmers' milk versus the profits of the corporate company.

Often the co-operative shareholding may have to take a defensive position and shareholders of the co-operative share find themselves with less rights than the publicly listed shareholders.

The PLC dairy model is seldom the leader in the market on milk price. A big, strong, dominant, 100% owned co-operative is needed among the processing group to protect the price of milk at the farm gate.

### **Regardless of the structure, performance is paramount.**

Performance and vision will drive the structure of a business. It would be a big mistake to introduce a new structure in isolation as the answer to turn the performance of a company around. Many people in the dairy industry hold up Ireland's Kerry Group as the model to follow. *While Kerry have done exceedingly well with their model, it must be clearly recognised it is the values and performance of the Kerry people, that have made the company and the business model work so well.*



## **Summary**

I started my Nuffield study trip with two intentions, to:

- 1) find the recipe for success in the 'value added' business
- 2) find good reasons to bag the co-operative and find an alternative as the best model to manage Fonterra's large milk supply

To my initial dismay and then growing pleasure, I identified the real value of New Zealand milk is the structure of Fonterra. With its unusually large share of New Zealand's milk, the 100% farmer owned co-operative, warts and all, is the best model to ensure this structure prevails.

The global commodity and ingredient business offers New Zealand dairy farmers an exciting and enriching future.

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## **Fonterra's Proposed Capital Structure**

While it is not my intention to comment on Fonterra's proposed capital structure in great detail, my report makes it clear that I disagree with the recommendations of the Board and management. My studies have impressed upon me that it is Fonterra's structure that is vital to farmers. The Fonterra Board and management have to be held accountable for their strategy and decisions that arise from these actions. The Fonterra Shareholder Council is now presented with a defining moment. I would encourage all farmers to read the three following articles, which I have included, in an effort to further this debate.

## **ARTICLE 1**

### **Voice of experience: take care** ***Dairy Exporter January 2008***

The former managing director of Fonterra Ingredients, John Shaskey, has words of caution for farmer shareholders about the proposed Fonterra capital restructuring.

He said on the face of it Fonterra has provided plenty of time for farmers to consider their options, which is positive, but the first farmer shareholder vote in May is crucial. It sets the model for how Fonterra will function in the future.

“Once that structure is in place it will be only a matter of time before the pressure to bring in external capital becomes irresistible.

“What appears to be a long lead-in is not that long at all. This is a big decision with huge ramifications for Fonterra farmers and the New Zealand economy in total. The significance of the capital structure has been clearly stated by the leadership of Fonterra, but the importance of the first decision in May next year may have been lost a little in the total message.”

“My prime concern with what has been proposed, however, is I think Fonterra has the business model wrong in what it has put forward in the restructure plan.”

Shaskey has had more than 30 years first hand experience in the business.

He acknowledges that Fonterra needs money to fund its strategy, but doubts that the strategy is sufficiently clear to farmers to enable them to understand the direction the company will take, should it be listed. He is concerned that the strategy is not well enough delivered or communicated within the Fonterra organisation to enable staff to have a clear sense of the mission they have.

“My experience of strategy development, at the highest levels of Fonterra, was underwhelming,” he said.

“Generally the output of these planning processes was a series of one-liner slogans or jargon and even bullet points that set a direction at a very high level,” he said.

That made it difficult for people at any level in the company to understand what their part of the business was supposed to deliver and what part they would play.

“The strategy is pitched at such a level that essentially there is nothing that doesn’t fit, and when opportunities arise there is often a ‘first-up-best-dressed’ feel about prioritisation.

### **Clever people**

“The one liners sound compelling, and have been crafted by some clever people, and would be great if you could feel confident that there was something backing them up.” Shaskey challenged Fonterra to articulate a strategy, in simple clear terms, and at a level of detail that would entice an existing shareholder to sell a business

that has taken 120 years and generations of farmers to build. He said Fonterra is telling shareholders that the strategy is the driving force behind the need to get more capital into the business. "It must be a compelling proposition and well understood."

He said that to date the Fonterra strategy outputs have been that it's all about fresh milk and behind borders."

The 'borders' the fresh milk is behind seem vague, as does the rationale for Fonterra to take a role in producing, processing and selling it.

### **Lack of clarity**

He said the value of proposition for Fonterra lacks clarity. The milk that Fonterra will be interested in will be in countries with lower production costs than New Zealand and will ultimately challenge the country's competitiveness.

The market that presents the opportunity to pursue the strategy of creating a supply source to meet the requirements of increasing domestic consumption is China, he said.

"Other countries with the potential to significantly increase milk production will be largely reliant on sales opportunities in the international market, in competition with supply from New Zealand."

He asked:

- Where are the behind-borders sales opportunities for fresh milk that drive the strategy? Is it the US, European Union or Japan where milk costs a lot more to produce but profit margins are high?
- Does Fonterra intend to enter markets with fresh milk produced behind their borders?
- Is the fresh milk strategy all about South America or Eastern Europe and securing a long-term supply of milk to process and export into world markets off a lower cost-base than New Zealand?

It would be understandable why such an approach would have more appeal to new investors in Fonterra rather than the current New Zealand farmer owners, he said.

### **Leverage**

If the strategy is about exporting ingredient dairy products from lower-cost producing countries in conjunction with supply from New Zealand, to better leverage the Fonterra sales network and customer relationships, is it necessary to invest in milk production in those countries?

"There may well be a very clearly thought-through approach to all these issues but, if there is, I don't think it has been communicated to farmers at this point in the process and there needs to be a lot more clarity than exists now." he said.

“I have this sinking feeling that the expectation within Fonterra will be that the smart one-liners will carry the day with farmers and there won’t be a lot of need to explain the strategy much more.”

Shaskey said his other area of significant concern with the Fonterra Capital structure proposal is around the intended structure of the new listed business.

He has serious reservations about the sense of maintaining the present Fonterra structure that bundles together the commodity and added value businesses. He said that there has been a less-than-constructive tension within Fonterra, and previously the Dairy Board, between the different businesses within the organisation.

### **Single-minded**

“This is not new. It has been a problem for a long time now and this restructure could get it sorted out once and for all. The problem is that you have a group of people going to work every day in the Fonterra commodity business with a single minded ‘mission’ of maximising the value of milk – i.e. focus on the milk price.

“In the Fonterra Brands business, you have an equally dedicated group of people going to work with a ‘mission’ the maximise profits from their brands. For them the milk price is the single biggest determinant of profit and the lower the cost they can get for it, the better their margins will be.

“These conflicting drivers don’t sit well in the same organisation and have been the cause of many internal debates – often with a lot more heat than light being the result.”

“The internal transfer pricing processes have not really dealt with the conflict and the outcome is less than ideal transparency as to the real performance of the component parts of Fonterra,” he said.

“In moving into a new structure, real consideration needs to be given to either keeping the commodities business within the cooperative, or fragmenting the listed entity into two parts – Fonterra Ingredients and Fonterra Brands. There is value to shareholders in owning both businesses but value loss when you try to operate them as one.”

Separation was the pathway chosen by Dairy Board, and initially by Fonterra, to deal with the conflicting drivers in these businesses, he said.

New leadership brought a change to this approach and ‘One Fonterra’ was introduced. The outcome of that has been a step backwards in terms of understanding the performance of the respective parts of Fonterra, a transfer of value from the commodities business to value-add, and a consequent distortion in the perceived value of the constituent parts of Fonterra, he said.

### **Recent focus**

This has been readdressed to some degree with the more recent focus on strategic business units within Fonterra but the basic conflict in business drivers remains and will continue to until a more complete

separation occurs. This separation could include separate boards of directors.

Challenged on why he left Fonterra at a time of such significant change, Shaskey said he did not think he was able to significantly influence the shape of the change ahead.

“For me, Fonterra was becoming a frustrating place to work and I had increasing reservations as the direction the company was taking,” he said.

“To me, it felt more and more that it wasn’t so much about how Fonterra was actually performing that counted, but how Fonterra’s performance could be made to look.”

## **Committed**

“I had committed a lot of my life to Fonterra and was, and still am, a great believer in what it means for New Zealand and its potential to the global dairy powerhouse. I had worked through the merger process, led the Jedi programme which essentially established the operating model for the Ingredients business, and had led the Ingredients business to the point where we were able to capitalise on the market conditions that led to the boom in commodity prices.

“After 30 great years in the business, and another restructure on the horizon, it seemed like the right time for me to go. I wanted to go before the frustration became cynicism.

“Fonterra is a great company with some great people and I wanted to go on my terms. I was a member of the leadership team and I had a responsibility for leading a lot of people in the company and they need to be led someone who bought into the emerging culture of the organisation more than I had.

“I had reservations around the direction the capital restructure review was taking and felt that if I could not support something as fundamental as that, then maybe I needed to be outside the company.”

Since leaving Fonterra, Shaskey has established Global Dairy Network, a trading company working with dairy manufacturers and customers in New Zealand and internationally. The network has been established with some former Fonterra colleagues, most well known being Colin Jones and Don Learmonth, and will focus on understanding the dairy ingredient needs of customers and finding the right product to match supply.

“Global Dairy Network is great fun.” Said Shaskey.

“We have a very clear understanding of where we fit in the world and what we want to achieve.

“Those aspirations are very modest when compared to the scale and significance of Fonterra, and the current debate that farmer share holders are involved in is crucial to the long term health of the New Zealand economy.

“I trust they will insist in real information before they get asked to vote on their future.

## **ARTICLE 2**

### **100% Farmer Owned Fonterra A Viewpoint Countering the Fonterra Capital Structure Review**

**Harry Bayliss & Michael Joyce**

#### **Executive Summary**

We are opposed to the preferred option for Fonterra's Capital Structure as presented on 15<sup>th</sup> November 2007. The presentation fails to justify the concerns held by the Fonterra Board that have been claimed to necessitate a Capital Structure Review. Even if these concerns are accepted, for the benefit of discussion, the Preferred Option does not mitigate these concerns. Worse still, the Preferred Option will inevitably lead to a loss of Farmer Control and to a significant destruction in the value of Dairy Farmers investment not only in Fonterra but in the value of their farm business overall. In turn this will lead to a massive impact to the wider New Zealand Economy.

While it is believed that the current Capital Structure is sustainable, there are alternative solutions that are worthy of further investigation, which do not appear to have been canvassed by the Review. The bottom line is that farmers must not lose control of our Cooperative and the core assets that underpin the value of our farmers business.

The underlying primary challenge facing Fonterra, is not the present Capital Structure, but the company's overall economic performance falling short of where it must be, and significantly short of where it potentially could be.

#### **Introduction**

The Fonterra Board has been through a review of current Capital Structure and on 15<sup>th</sup> November 2007 presented their preferred option to shareholders at a Special Meeting broadcast to seven different venues around the country. Shareholders had no prior notice of any information relating to the preferred option and a written form of the presentation was not available until several days after the meeting.

#### **Fonterra Board Preferred Option (a summary)**

Fonterra shareholders will vote in May of 2008 to approve the establishment of a new company, '**Fonterra**' (a Corporate not a cooperative). The shareholder vote will also mandate the transfer of all the assets and liabilities currently held by Fonterra Cooperative Group to '**Fonterra**'.

In May 2010 a second vote of shareholders will mandate the 'Fonterra' Board to list '**Fonterra**' on the Stock Exchange with an initial 20% of shares in Fonterra floated publicly on the market, with a further 15% of shares allocated to existing Supplying Shareholders. The remaining 65% of shares would be held by Fonterra Cooperative.

Supplying Shareholders will elect 8 Directors to the Fonterra Cooperative Group and a further 2 Directors would be appointed as independent Directors. This Board would then appoint 6 Farmers Directors to the 'Fonterra' Board with a further 4 independent Directors being appointed.

### **Fonterra Board Rationale**

The rationale given by the Fonterra Board in the presentation, for the Capital Structure review and the Preferred Option, was that the current Capital Structure: -

1. Exposes the Company to unsuitable redemption risk.
2. Does not allow farmer choice.
3. Will not allow the delivery of the Fonterra Strategy due to insufficient capital.

So let's have a look at each of these issues individually.

### **Redemption Risk**

The fear is that if a significant number of farmers either decide to change their land use (e.g. retire from dairying & put on beef stock) or take the decision to supply their milk to a competing Dairy Company, then the cost of share redemption would significantly challenge the Balance Sheet strength of Fonterra.

While it is inevitable that a small number of farmers will make a lifestyle choice to cease dairying, it is unlikely that the numbers will be sufficient to cause a significant threat. Indeed much of this land may either support surrounding dairy farms to increase production by supplying feed or conversely may in a relatively short time return to dairying with a new generation of dairy farmer.

Farmers who take the decision to supply a competing company are potentially a greater issue. They are not only taking their capital out of Fonterra but also ensuring that a greater volume of NZ dairy product is available to our customers, driving a reduction in potential returns for all products.

But the fundamental issue here is not that they have left, but that Fonterra's performance has been insufficient to ensure that they are worse off economically by leaving.

It can be argued that the potential redemption risk is a very positive discipline driving company performance. The better the performance, the lower the redemption risk and visa versa.

### **Farmer Choice**

It is argued that there can be a big variation in the attitude of individual farmers. For example, their view on the balance between Milk Price Payout, Investment Return and Business Value Growth or alternatively their view on the balance of risk and return. For this reason it is argued that the single Fair Value Share system, directly linked to production levels, is too inflexible.

However the amendments to Fonterra's Constitution two years ago allowing supply based on contract or the deferral of the need to be fully shared against production means there is significant flexibility available to farmers.

In addition, some people would argue that too much choice is not in anyone's interest because of the resultant complexity and cost of systems, and the confusion around defined direction. By and large, if farmers know the rules, they can be quite innovative in their ability to maximise their own situation within those rules.

### **Lack of Capital to Deliver Fonterra's Strategy**

The argument here is that part of Fonterra's Strategy is to invest significantly offshore to develop business opportunities in a number of key markets. Specifically it entailed the targeted investment in White Milk sourcing, processing and marketing within the borders of countries such as China to take advantage of the rapid development of such markets. This strategy could potentially require significant capital requirement.

While the wisdom of this strategy could be debated, it is not the key to this part of the discussion. The key point is whether Fonterra's growth is indeed constrained by a lack of capital. And if so is the Preferred Option the best way of addressing the issue. While Capital can be a constraint on business growth, it is normally not the greatest constraint. The ability of management to handle growth is normally of far greater importance.

It is unfortunately a fact that Fonterra's business performance has not been where it needs to be. The significant businesses we currently own have overall, not delivered a return above the cost of capital, even in a relatively low commodity price environment. In the current high commodity price environment, the challenge is significantly higher. If our current business was performing as it should be, we would have sufficient profit being generated year on year to allow material reinvestment in growth if and when the opportunities arise.



Normal business practice would suggest that 40% of net profits should be retained to fund growth.

Unfortunately access to further capital could well make the current underperformance an even greater problem.

So we can see that the issues claimed to necessitate a Capital Structure Review, have not been justified.

Even if we are prepared to accept for the benefit of discussion, that these three points are indeed issues, we need to test whether the Preferred Option resolves them.

### **Preferred Option vs. Redemption Risk**

Under the Preferred Option the value of the Cooperative shares will be set by reference to the traded value of the '**Fonterra**' shares. Therefore when shareholders wish to leave the cooperative, their shares will be redeemed at this value and the cash paid by the Cooperative will need to be funded out of the Cooperative Balance Sheet.

While initially the Cooperative will be able to consolidate the Balance Sheet of 'Fonterra' in to its own, the fact that the only asset it will own, will be the shares in 'Fonterra', will limit its ability to finance any share redemption. This will inevitably lead to a further sell down in shares in 'Fonterra'.

This is exactly what happened in Australia. Bonlac farmers initially set up Bonlac Supply Cooperative (identical structure as that suggested for Fonterra Cooperative) and sold 25% of Bonlac Foods to NZDB. Despite Bonlac Supply Company having far greater constitutional protection against cash redemption, it still came under increasing pressure and did not have the Balance Sheet strength to maintain the support of it's bankers. As a result they were forced to continue to sell down, and have ended up owning nothing other than a supply right to Bonlac Foods, ironically now called Fonterra Australia.

While it will be argued that there will be protections in place to stop sell down past certain points, in exactly the same way that pressure increased for Bonlac Supply Company to sell more of Bonlac Foods, so it will be with Fonterra. Even the 35% minimum shareholding to be set in legislation will not last 5 minutes when the balance sheet pressures are great enough.

So the upshot of all this is that rather than reducing the redemption risk of the Company, it will simply be transferred away from 'Fonterra' to Fonterra Cooperative and because of the less liquid Balance

Sheet, the issue will be magnified significantly for Fonterra Cooperative.

### **Preferred Option vs. Farmer Choice**

At the outset it needs to be emphasised that farmers will only own shares in Fonterra Cooperative as part of their supply. While existing shareholders will be allocated shares in '**Fonterra**' at the time of establishment, this will not be the case on an ongoing basis. It will only be farmers who decide to buy '**Fonterra**' shares on the sharemarket, just like you can buy shares in Telecom, who will directly own shares in the downstream business of '**Fonterra**'.

It should be also remembered that Fonterra Cooperative will simply be a shell company. None of the manufacturing plant will be owned directly by Fonterra Cooperative, and the tanker dockets, and even your monthly payment statements will all be printed by a company farmers do not directly own. This is again exactly the same situation with Bonlac Supply Cooperative.

So while it will be argued that the Preferred Option will give farmers greater choice, it could also be argued that we have ample choice available now and this option actually reduces choice significantly.

### **Preferred Option vs. Providing Capital**

The Preferred Option looks at floating 20% of '**Fonterra**'. There have been various figures put forward suggesting that the capital raised would be in the vicinity of NZ\$2.5 – 2.8 billion. It should be noted that because of the change in the structure there will be a need to regear '**Fonterra's**' Balance Sheet to maintain our existing Credit Rating. This is likely to require NZ\$1.8 billion to be retained for this purpose. As a result of this there would be only NZ\$0.7 – 1.0 billion actually available for the capital program that is deemed to be necessary. Quite clearly this would not be sufficient to fund the sort of projects that are possibly being mooted. In which case a further float would be necessary to fund further growth.

So there is no doubt that it is quite misleading to suggest that floating 20% of '**Fonterra**' will lead to a stable viable solution. As further shares were floated Fonterra Cooperative's share of the company would reduce, leading to an even greater pressure on its Balance Sheet. This would unfortunately be as inevitable as it would be irreversible.

### **The Fundamental Conflict Between Farmers Supplies and Shareholders of 'Fonterra'**

The dairy industry has been through at least four different Capital Structure Reviews in the last 15 years. In each of these reviews the

current Preferred Option was looked at but was discounted very early in the process because of the fundamental conflict between the farmer supplies and the shareholders in '**Fonterra**'. In the model we cannot assume that farmers will be shareholders of '**Fonterra**' on an ongoing basis. We can see that farmers will be wanting as high a milk price as possible to maximise their farm profit, whereas the shareholders of '**Fonterra**' will want the lowest milk price to maximise the profit of '**Fonterra**'. This is a fundamental conflict that will not be resolved.

Our current model handles this conflict by ensuring that supply and ownership in the company are directly linked. It means that the Board and Management can be confident that the interests of farmers, as milk suppliers and as shareholders, are aligned. They are therefore in a position to give the company direction without constantly grappling with this conflict.

The Board of '**Fonterra**' in the Preferred Option will be significantly conflicted. In the Bonlac Foods situation, when it came to setting the milk price, it was a farcical situation. Because the farmer elected Directors were conflicted, and the Fonterra appointed Directors were conflicted, the decision to set a milk price was made by the two independent Directors. All other Directors literally left the Board Room to allow discussion and a decision to be made by the two independent Directors.

So where do we go from here.

Rather than simply say that there are no compelling reasons to change from where we are, and that the Preferred Option is unacceptable, therefore we should stay as we are, perhaps we need to ask if there are other ways of addressing perceived concerns. For debate then, the following is put forward as one example of an alternative.

### **Alternative Proposal**

If we assume that in the future there will be investments that may be at the margin, either in terms of risk profile or sheer volume of capital required, let us look at another way of providing the necessary capital without disrupting the linked ownership and control we currently have in Fonterra.

In this model Fonterra sets up Venture Capital Companies, as and when necessary, specifically targeting certain investment profiles.

#### ***Venture Capital Company No.1***

This company may, for example, have a stated business intent of investing in a high return, low value growth strategy. This would be

the cash cow type business where the initial business investment would be relatively high, with minimal value growth but the business would produce regular, dependable returns.

### ***Venture Capital Company No.2***

This company could, for example, have a stated business intent of investing in a high risk, high potential value strategy. This would look at start up, leading edge technology ventures with a relatively low initial business value and little or no dividend stream, with even the likelihood of further capital injection necessary but with the possibility huge value growth.

Now these are probably examples at the extreme and there are likely to be a number of potential examples in between.

This model would have Fonterra owning a controlling shareholding in each of these venture capital companies but the rest of the company could be listed. Each company would be likely to attract a different profile of investors depending on their own individual respective risk preference.

These companies would have the ability to invest along side Fonterra, in investments Fonterra believed fitted its overall Strategy. So for example the investment in setting up a Dairy Farm in China, may suit the profile of one of these companies so Fonterra would invest 50.1% in its own right and the other 49.9% could come from the Venture Capital Company. As a result it would reduce the absolute exposure of Fonterra, and hence Fonterra Shareholders, while allowing outside investors, including farmers, whose risk preferences fitted the investment, to be involved.

The model would allow the risk of each investment to lie to a far greater extent where it should. In the Preferred Option it is claimed that a float would be very successful. A major contributing factor in this is that the 20% floated portion of the shareholding would, to a large degree, be underwritten by the individual Balance Sheets of the Milk Suppliers.

### **Conclusion**

This Discussion Paper concludes that, while there are no compelling reasons to change from the Capital Structure we currently have, the Preferred Option not only fails to address perceived weaknesses, it will inevitably lead to the loss of farmer control and a huge destruction in Farmer business value.

The real concerning issue in this Capital Restructure Review, is that the 'Board has lived and breathed this for a year.' The issue that has so urgently needed the whole team focus, specifically the need to lift

performance significantly in a rapidly changing marketing environment, has not had the priority that it requires.

It is hoped that farmers understand the key points put forward in this paper. It is essential that there is widespread and considered debate amongst Fonterra Shareholders. We hope that you will take the opportunity to take part in the debate and ensure that your feedback is forwarded to your Shareholder's Councillor or on Fencepost if the opportunity is available.

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## ARTICLE 3

### Capital Structure at Fonterra: a discussion paper

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**2 January 2008**

*(Anyone receiving this paper may forward it to other people who they think may be interested. Given the difficulty of dealing with complex matters such as this in the news media, my current intentions are not to send it to any news media. If by chance this paper does get forwarded to any of the media then it is not to be published without contacting me for approval. Approval will only be given if there is an undertaking to publish the complete paper. Comments can be sent to [woodfork@lincoln.ac.nz](mailto:woodfork@lincoln.ac.nz))*

Now that Fonterra has announced its preferred capital structure model, the challenge for dairy farmers is to decide whether this is the path they wish to follow. In doing this, farmers have to get beyond the headlines and the rhetoric, and look at the substance.

The purpose of this paper, therefore, is to explore the issues that farmers need to be thinking about.

#### **Strategy Comes First**

The starting point before looking at structure is always to look at strategy.

In this case, Fonterra's strategy is very simple. It wants to grow. And it wants to grow not only in relation to processing and marketing NZ milk, but also in relation to lots of other countries' milk.

Fonterra's traditional core strengths (which go back to the days of the Dairy Board and the multiple co-ops that supplied product to that Board) have been in cost-efficient processing and marketing of commodities. Over time, Fonterra has also developed core strengths related to marketing of ingredients to other companies. And even more recently there has been an increasing focus on 'brands'. However, the Fonterra brands business is mainly within Australasia, plus modest but also important strengths in some parts of Asia. In a global sense this brands business is quite small.

*To reiterate this point: Fonterra is Number 1 in the world when it comes to dairy commodities and dairy ingredients, and the marketing of these internationally. It is no more than a 'small player' when it comes to global brands and fast moving consumer goods.*

Fonterra believes that most dairy growth is going to be in fresh products. The problem is that NZ milk supply cannot be used for fresh products in global markets because of our location. Accordingly, any major move into fresh branded products overseas is going to use other people's milk. Therefore, it is not going to increase the milk return that farmers get for their own milk. Rather, it will provide a return on additional capital invested.

This brings me to another key point that needs to be re-iterated. *Global investment in a brands business is not about increasing the returns that farmers get for their own milk, but about providing an increased income stream related to the investment of capital.*

The next question that needs to be asked is whether Fonterra has core strengths in this area of brands. In fact I have already indicated that this is at least debatable. To the extent that Fonterra does operate in this market segment, then it largely relies on bought-in expertise. This is illustrated by the fact that Fonterra's senior management largely comprises expertise bought on the world market. There is nothing wrong with this, but it is something that all of Fonterra's competitors can also do with no less effectiveness. *So it is purchased expertise rather than core competencies within the organisation.*

This leads inevitably to another question. Why would we expect Fonterra, headquartered in New Zealand, to be any better than any Chinese company at producing, processing and marketing milk in China, or any Brazilian company marketing milk in Brazil? History tells us that Australasian beer companies got a real bruising (indeed a fatal bruising) when they thought they could beat either the local or the international opposition relating to Chinese markets. And getting back to milk, Fonterra has already acquired some bruises trying to operate in countries like Mexico. The reality is that as Kiwis the knowledge and expertise that we have about producing milk from non-pastoral sources, and then selling that milk in supermarkets to people with cultures different to our own, is quite modest. *It is not a field in which we have a natural competitive advantage.*

So that leads to yet another question. Is the behind-borders growth strategy the right one for NZ dairy farmers? Surely the primary need of NZ dairy farmers is to be able to sell their own milk for the best price possible. That business is always going to be based on long life products. That still means there can be branded products ranging from cheeses to UHT milk to infant formula. It may also include having marketing arrangements to sell other countries' commodities and ingredients (as is currently occurring) to 'cash in' on marketing synergies. But actually producing and marketing fresh products to consumers behind borders is quite a different business. In fact it is a business with a totally different business philosophy.

This can be restated in summarised form as follows. *The traditional Fonterra business is about cost efficient operations and food technology, and business-to-business marketing. The proposed growth business is about product differentiation, entrepreneurship, and consumers.* Trying to combine these within the one company will always be a challenge.

What I have shown to this point is that the so called growth strategy has lots of challenges associated with it. But even assuming that Fonterra could excel in this sector, would the proposed structure deliver the goods?

### **The Initial Listing**

The initial listing of 20% of Fonterra can be expected to bring in about 2 billion. (This assumes a current Fonterra value of about \$8 billion which is broadly in line with the capitalised current fair value share but considerably greater than balance sheet equity). From a balance sheet perspective this would then allow Fonterra to take on perhaps another 2 billion in debt finance, making \$4 billion in total. (But as will soon be shown, actually servicing this extra debt brings its own set of additional issues.) What would this additional capital buy?

Some examples of market capitalisations in the dairy and food industry are (in \$NZ):

Dairy Farmers Australia	about 1.2 billion
National Foods Australia	about 3.3 billion
Numico	about 20 billion
Danone	about 60 billion
Nestle	about 300 billion

So the Stage 1 listing would potentially allow Fonterra to become a reasonably big player in Australasia. I say 'potentially', because although Dairy Farmers Australia is likely to come onto the market within the next year or so, this is unlikely to be the case for National Foods (which has recently been purchased by Kirin for \$AUD2.8 billion, including taking on about 1 billion of existing debt with National Foods). But at least in theory it means that Fonterra could approximately double its presence in the Australian domestic market if it were to use all of the additional capital for this purpose.

It is worth looking at the amount of money that could be earned each year from this investment. National Foods is expected in 2008 to earn about \$AUD200 million before interest, tax, depreciation and amortisation. If Fonterra were to purchase a business like this, then after interest payments on total new debt the amount available for depreciation, re-investments and dividend would be about \$100 million. What this illustrates is that there would actually be very limited cash to provide a return on the \$2 billion of new shares.



Going beyond Australia, a good example is provided by Numico. Once again, this specific investment opportunity is unlikely to arise, because this Dutch Company, which specialises in infant formula, has just been sold (late 2007) to Danone for about \$NZ20 billion. But it indicates the scale that is needed to become a major player. Numico in fact only pays very small dividends and so Fonterra would have to pay for almost all of it through equity capital. By my calculations, the co-operative would need to reduce its shareholding to less than 30% to bring in enough new equity capital to fund this. And having done so, the new Fonterra would be about 9% of Nestle.

This illustrates yet another important point. The dominant marketers of dairy products to consumers are food companies, not dairy companies. There are major synergies in being able to market both dairy and other food products together. (Kirin obviously thinks this extends to dairy and beer.) This is at least part of the reason why dairy companies coming on to the market are 'snapped up' by food companies at high capital purchase to earnings multiples.

The third option would be for Fonterra to invest in China in a big way. Actually that needs to be qualified: big for Fonterra and NZ but not all that big for China. China already has about 9 million dairy cows. It is not possible to provide specific example of companies that could be purchased in China, but the challenges of working in this environment have been illustrated once again in recent weeks with Danone and Bright Dairy failing to resolve their differences, and the consequent demise of their joint venture relationship. So a China strategy may indeed have great potential but it also has great risks.

At this point it is worth going back and looking at the three Fonterra-defined issues which are the drivers of the proposed changes:

- a) redemption
- b) choice
- c) growth

Associated with these is the supposedly non negotiable requirement that farmers keep control.

### **Redemption Issues**

Fonterra seems to be suggesting that the redemption issue is largely solved by the proposed new Fonterra company structure. This is correct for the publicly listed company. But Fonterra appears to have not fully recognised the redemption issues for the 'new' co-operative.

The only assets this co-operative will have after listing will be its 65% (initial) shareholding in the Fonterra listed company. If Fonterra were to lose (say) 20% of its supply then the only assets it could sell would be its shares in the company. This would have obvious implications for shareholder control, particularly if the co-operative share of the public company had already dropped below the initial 65% through on-market capital raisings.

Currently, if Fonterra Co-op faced a redemption risk then it has tangible assets to use as security. But in the new co-op, the company share assets will not be regarded by the investment community as particularly good security. And of course the interest charges will be a cost against remaining shareholders.

So the reality is that the proposed model does not solve the redemption risk. And the only 'out' would be by selling shares and thereby risking control.

### **Choice**

The new model does give farmers some investment choice, in that they can either sell or purchase listed company shares. Hence they will have choice over the total extent of their business investment. But where they will not be given choice is in the *type* of investment that they wish to make. Their investment will span the whole range of the company's activities (relating to NZ produced milk, 'behind borders milk', fast moving consumer goods etc) in the same proportion as the company actually undertakes those activities.

### **Growth**

The proposed model definitely gives scope for growth but it does not provide scope for Fonterra to become another Nestle or even a mini Nestle. If the new investments are successful then there is scope for enhanced returns to Fonterra's farmers through the investment return. If the growth strategies are unsuccessful then value-added component will decline. In a worst case scenario Fonterra (the listed company) would need to take on increased equity leading to a decline in the proportion of the company owned by the co-op.

### **Will the Proposed Model be Attractive to the Market?**

History suggests that 'mum and dad' investors will be attracted to buy shares in the new Fonterra company once listing occurs. Iconic companies are always attractive to this segment of buyers. But canny investors and the institutions may be more cautious. History also shows that investors often make their best returns through takeovers, and this is going to be much less of an option with Fonterra given the proposed company rules. The market can also be expected to react negatively to the limitation on overseas ownership and the requirement that the company remain headquartered within NZ. And investors, just like farmers, will be extremely interested in how the milk price is going to be determined. The tensions and uncertainty around that issue should never be underestimated.

### **Returning to Strategy and the Over-riding Issue of Risk**

Conventional wisdom has been saying for many years that the future lies in value adding. But events of the last 12 months require that we rethink that position. Indeed the overall trend has been for dairy prices to be increasing for about 10 years, and it has only been our

exchange rate increases since 2001 that have tended to obscure that fact. I recall that Warren Parker (CEO at Landcare Research and a former Farm Management Professor at Massey University) suggested at the Alistair Betts Memorial Seminar in Christchurch in mid 2006 that we needed to restructure our thinking to a world in which resource-based industries would be increasingly important. The evidence was already there but most of the audience could not see it, and ignored Warren's insightful comment. It has also been evident for quite some time that Europe has become a graveyard for making value-add margins on dairy products, and that the major companies are trying to divest and shift their value-add operations east to countries such as Russia and China. It is all very competitive! And we have further evidence in that Fonterra's value-add returns this year are only expected to be 20c per kg MS, or about \$250 million in total. (How such returns of 20c can support the proposed 2008 fair value share of \$7.22 is in itself an important matter for reflection; it certainly exceeds the price to earnings multiple for publicly listed comparable companies).

Accordingly, the big strategic question for Fonterra farmers is why would they wish to risk their major business (producing milk) which currently is and seems likely to remain very profitable, to seek gains which are unlikely to be huge, which will go to the people (including farmers) who supply the additional capital rather than those who produce the milk, and which are inherently high risk.

### **Is there a Superior Structure?**

The starting point for this discussion paper was that strategy precedes structure, and that point needs to be returned to here.

If the strategy is to market NZ milk, then the existing co-operative structure, with perhaps some fine tuning, has quite a lot to recommend it. Some of that fine tuning might be around the transparency of the fair value share price, and the way that it is calculated. Certainly, the current price to earnings multiple is remarkable, and that in itself increases the redemption risk. (It has also been a very convenient source of cash to Fonterra in a time of growth.)

If the strategy is to be one of growth, based on marketing other people's milk, and indeed operating behind borders in the fast moving consumer goods business, then the existing structure will need to change. But Fonterra may have moved too quickly to dismiss other structural options that could support such a strategy. Marv Pangborn and I set out one of those options in the April and May 2007 issues of the Dairy Exporter. Fonterra says that it does not like that particular option because it loses the benefits of the 'cow to plate' operation. But that is not necessarily so. That option involves two companies with the processing, commodity and ingredient

marketing assets held in the co-operative company, and the brand assets for fast moving consumer goods held in an investor oriented company. The co-operative might retain brands for long life products. I do not propose to go into the details of that option again here. My point is that there are other options (including potentially others such as those put forward by John Shaskey, Harry Bayliss and Michael Joyce in the January 2008 Dairy Exporter), and that these options can achieve the Fonterra growth strategy with less redemption risk and more individual choice than what is currently proposed. Perhaps most importantly, there would be less risk of farmers losing control over those parts of the business that they need to control.

### **Does the First Vote Matter?**

Yes, it does. Once the first vote is taken, and the proposal is passed, then the subsequent debate will be greatly narrowed. The first vote is all about getting strategy and structure aligned. The second vote provides a check on whether there is support for final implementation of the chosen outside investor model. The decision that is currently before Fonterra's farmers is bigger than even the decision to form Fonterra some seven years ago. It is a decision that needs very careful consideration.