

Spierings' Fonterra has creat



Hugh Stringleman
hugh.stringleman@nzx.com

FONTERRA'S performance since formation in 2001, especially since listing in late 2012, has been the subject of much discussion around farm house kitchen tables, in supplier meetings in country halls, among Wellington regulators and in the media.

More than 10,000 supplying shareholders and several hundred investors in the Fonterra Shareholders' Fund (FSF) have views on the giant's performance ranging from laudatory to sceptical to dismissive.

Farmers Weekly has printed a range of views in a series called Fonterra's Scorecard preparatory to the Government's review of the dairy industry by the Ministry for Primary Industries this year.

Some conclusions are summarised here under subject headings and the report card is mixed.

Processing

New Zealand's only multinational, Fonterra, employs about 20,000 people and earns about 15% of the country's export income.

From that income the co-operative pays \$10 billion annually to farmers, its shareholders, for the never-fail collection of 17b litres of perishable milk.

In recent years Fonterra has picked up, processed and sold the resulting dairy products effectively and without fuss.

Its well-publicised failures – the buttermilk lake near Taupo, the wastewater overload at Hawera and the botulism scare at Hautapu – occurred at the 2013 peak.

That was the season when farmers produced 8% more milk.



Later seasons have seen lower volumes.

Because of a slow-down in the expansion of the NZ dairy industry and loss of some suppliers to competing processors Fonterra now has 10% more processing capacity than it needed at the peak of spring milk production for the past two years.

The overcapacity has led to fears of stranded assets and costly overheads, which the company strongly denies.

Former strategy general manager Alex Duncan said the basic business of dairy processing hasn't been profitable for many companies around the world but Fonterra manages it well.

Fonterra has supply-chain IP from the farm vat to ship's side, all generated by the continuous drive for efficiency demanded by co-operative ownership, the Milk Price Manual (MPM) and the pasture curve.

NZ farmers, and their Australian counterparts, need only recall the sad recent history of Murray Goulburn co-operative for an unacceptable alternative.

Duncan chose to look on the bright side of the excess processing capacity, saying it extends product options into the peak – Fonterra's ability to make the most out of every bucket of milk.

He also thinks most Fonterra farmer-shareholders consider their average \$800,000 in supply shares the necessary stake in pick-up and processing to have viable farming businesses.

But that doesn't exempt the directors and senior executives from key performance measures.

Profitability

When one of the most experienced and respected rural economists in the country's largest trading bank draws attention to Fonterra's dismal earnings and dividends record (see p10) farmers will take notice.

Since listing Fonterra earned 37c/share or unit on average annually, 30c of which has been paid in dividends and 7c retained.

Chairman John Wilson said everyone in Fonterra strives every day to maximise the payout from every kilogram of milksolids and the split of that income between milk price and earnings is done by the MPM formula, insulated from any manipulation.

For the unacceptable alternative, again, see Murray Goulburn's record.

But Wilson also pointed out that 46c has migrated across from earnings to milk price by several tweaks to the MPM.

First NZ Capital research head Arie Dekker, one of the country's deepest thinkers on Fonterra not



GLASS HALF FULL: The Spierings-led achievements in food service and advanced ingredients are among the brightest bits of Fonterra's performance.

working for the co-operative, said farmers are unlikely to complain if a little more income comes by way of dividend on their \$800,000 investment rather than through milk price.

FSF unit investors would also be adequately rewarded – perhaps a reliable 6-7% return on capital rather than the actual average of 4.9% or the under 4% already signalled for this financial year?

Under chief executive Theo Spierings (2011-2018) Fonterra's strategy was to accelerate product development and pick up the pace of added-value.

It is not an exaggeration to say he fostered two whole new categories of products – food service and advanced ingredients, now collectively 30% of all milk used by Fonterra around the world.

His tenure spanned an unprecedented period of demand from China for almost every product Fonterra makes, not to mention lesser economies in Asia and the Middle East.

On that world stage his record of profitability is poor.

ANZ's Con Williams said Fonterra's 2025 ambition is to increase earnings by 50-100% but 80c-\$1 earnings are a long way off despite some signs of improvement.

Milk Price

An inflation-adjusted series of milk payouts, averaged over all NZ dairy companies, for the past 16 years shows considerable volatility between seasons but no upwards trend.

For farmers that means increased income has come through expansion and onfarm efficiency rather than higher values for the milk they produce.

Unadjusted cash payouts averaged \$6.20 over the past seven years compared with \$5.75 in the previous seven years.

The increase was by way of milk



COMMITMENT: Fonterra Shareholders' Council chairman Duncan Coull says Fonterra has performed as a co-op should but lacks shareholder belief and purpose.

price, not dividend.

To which Wilson had two responses: the hidden effect of currency values and the improved position of NZ dairy farmers compared with European and American counterparts.

He argues the NZ dollar was closer to US40c during the first decade of Fonterra versus 70c average since 2009, an exchange rate difference worth \$3/kg.

But the highest return (\$7.66 in 2007-08) in the early decade came during a financial year when Fonterra's average NZD/USD conversion rate was 74c.

Subsequent record payouts, \$7.90 in FY 2011 and \$8.50 in FY2014, came with 72c and 81c average conversion rates respectively.

Sorry, the exchange rate against the USD has not been a major influence on the farmgate milk price (FGMP) for the past eight to nine years.

NZ has learned to live with and prosper from a higher value dollar.

Wilson was on stronger ground when comparing NZ FGMPs with those overseas, a favourable comparison lately, aided by that higher-value NZD.

PGG Wrightson

Electric DEALS
on fencing products

Terms and Conditions: All offers and prices are valid for dates specified or while stocks last. Prices include GST and are subject to change. Some products may not be available in all stores but may be ordered on request. Prices do not include delivery, delivery costs are additional (unless specified). Images are for illustrative purposes only. Our Customer Terms of Trade/Sale located at www.pggwrightson.co.nz apply to the sale of products listed here unless specified otherwise.

Red lightweight temporary fence post
UV stabilised for long life

Speedrite™ Plastic Red Tread-In 50 Pack

\$99 PK

Valid 1/6/2018 - 30/6/2018



Speedrite™ Geared Reel Prewound with Poliwire 500 m or Premium Super 8 Tape 200 m

\$95 EA

Valid 1/4/2018 - 30/6/2018

Freephone 0800 10 22 76 www.pggwrightson.co.nz

Helping grow the country

ed two new food categories

In the FY18 interim results presentation Fonterra included a graph going back 40 years that showed NZ milk prices consistently below the US and European Union until the 2007-08 global financial crisis (GFC).

Since then NZ has been more competitive and in recent months it was the leader, about US40c/litre.

At a conversion rate of 12 litres per kilogram of milksolids and a US70c exchange rate, the NZ price was NZ\$6.85/kg, ahead of both the EU and US.

However, the MPM and regular in-season adjustments to the forecast FGMP ensure NZ dairy farmers are first to benefit from upwards movements in global dairy prices.

They are also first to feel the impact of falling global prices, as Fonterra's graph also illustrates.

The graph shows the volatility of world dairy prices since the GFC and its immediate predecessor, the soft commodities boom.

About the best that can be said for Fonterra's performance on milk prices is an influence for stability and transparency with the Global Dairy Trade mechanism that might be more consistently delivering NZ farmers FGMPs that are equal to or better than the EU and US.

Value-Add

The Spierings-led achievements in food service and advanced ingredients are among the brightest bits of Fonterra's performance.

When the Waitoa cream and flavoured milk UHT plant was opened in 2014 he said Fonterra traditionally had produced commodities and consumer foods but little in between.

He set out to change that and secured agreement from the board for what added up to nearly \$1b of new processing capacity for

food service products, here and in Australia.

Food service products – cooking creams, cream cheese, mozzarella and cheese slices – now account for 11% of Fonterra's 23 billion litres of milk equivalent (LMEs), about \$2b of revenue.

The volume grew 27% in FY2017 and the gross margin was 27%.

Unfortunately, the latest update for FY2018 year-to-date third quarter shows nil growth in LMEs and a gross margin down to 24%.



NO MIDDLE: When the Waitoa cream and flavoured milk UHT plant opened in 2014 chief executive Theo Spierings said Fonterra traditionally had produced commodities and consumer foods but little in between.

Spierings said stronger competition from European companies in the biggest food service market, Greater China, has limited Fonterra from being able to pass through increased costs for the raw materials of fat and protein.

NZ's consumer products division, Fonterra Brands NZ, suffered a fall in sales volume and was reformed.

On the plus side, Fonterra Australia has become the largest dairy processor at 22% market share and attracts 400m litres more milk to exceed 2b litres.

Recently, the ingredients division NZMP publicised its

range and ambitions for advanced ingredients: dairy proteins, medical-grade lactose, SureStart paediatric ingredients, consumer milk powders, added-value solutions, risk mitigation services, quality assurances and the GDT platform.

The volume of the division amounts to 19% of Fonterra's total LMEs and divisional head Kelvin Wickham said advanced ingredients make higher, more sustainable returns for shareholders, without revealing the dollar value.

Only 58% of total LME is now classified as basic ingredients, GDT commodities or raw milk sales. Just under 10b LME or 42% of the total attracts added-value of some kind.

The only roughly comparable numbers from Spierings' first year were total sales of 3.9m tonnes of products, of which 2.8m were ingredients, with minimal added-value.

On his watch the ingredients classification has shrunk from 72% to 58%.

Governance

Departing Fonterra Shareholders' Council chairman Duncan Coull said Fonterra has performed co-operatively as it should but lacks shareholder belief and purpose.

Governance and representation were restructured during Coull's tenure, reducing the number of farmer-directors, changing the pre-selection process and the number of wards.

Back in 2012, after a few false starts, Fonterra also introduced Trading Among Farmers, a hybrid co-operative structure that enshrined the MPM, a market valuation for shares and a farmer exit route that removed redemption risk from the co-op.

None of those major changes was achieved without considerable debate by

shareholders, in the wake of which Coull has detected lack of loyalty.

It is difficult to make a co-operative mean all things to all people but the degree of dissatisfaction has to be a concern to the councillors and the directors.

The most visible sign is loss of milk supply to competing processors – down from 95% at Fonterra's formation to 82% now.

The latest focus has been the suspect investment in Beingmate, the Chinese infant formula company that has lost its way.

Not only has Fonterra been forced to impair two-thirds of a \$700m investment and book 19% share of repeated trading losses, much of the lost NZ milk market share has gone to start-up Chinese processors, backed and facilitated by the Chinese government.

Just as the Sanlu investment was former Fonterra chief executive Andrew Ferrier's biggest failure, Beingmate looms over the exit of Spierings and his former chief financial officer, Lukas Paravicini.

The directors must accept some blame for the Beingmate investment approval and its outcome.

Wilson will face the shareholders later this year, when his term expires, should he choose to stand again.

All he will say at present is that the transition to a new chief executive needs to be accomplished before he considers his own future.

Social responsibility

Is there any New Zealander who doesn't know that dairy farmers get up at 4.31am, whether Richie McCaw turns up or not?

Or that the dairy industry has a Sustainable Dairying: Water Accord programme that has been very successful in getting waterways fenced and riparian zones planted?

Or that 70% of primary schools have opted into Fonterra's Milk For Schools programme, ensuring 140,000 kids get a daily UHT milk, costing the co-op \$10m a year?

That's close to \$1000/farm annually, plus the low-decile school breakfasts and community grants.

For further examples, read Fonterra's first Sustainability Report, an impressive publication from the heart of the co-operative.

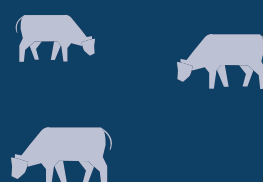
Fonterra			
Activity	Pass	Fail	Comment
Processing	✓		Every litre, every day, picked up, processed, paid for
Profitability		✗	Too little, inequitably shared by MPM
Milk prices	?	?	May be better than other countries, too early to tell
Value-add	✓		Steady transformation, not reflected in earnings
Governance		✗	One word: Beingmate
Social responsibility	✓		Living Waters, Milk For Schools, Sustainability

The livestock loan for Kiwi farmers

- It's fast and simple to put in place
- You choose where to buy and sell stock
- 100% finance available
- No repayments until stock are sold
- Security is taken over the livestock

openforlivestock.co.nz
0800 87 50 50

O4L OPEN FOR LIVESTOCK



HEARTLAND
BANK

Heartland Bank Limited's lending criteria, fees and charges apply.