Experts to analyse Fonterra from all angles

FONTERRA'S founding legislation, the Dairy Industry Restructuring Act 2001, will be re-examined this year from the grassroots upwards.

Agriculture Minister Damien O'Connor wants a comprehensive review of the DIRA to focus on environmental issues, land use and how to achieve the best outcomes for farmers, consumers and the economy.

When it was formed Fonterra collected 96% of milk with the rest shared between fellow co-operatives Tatua and Westland.

The DIRA enabled Fonterra to exist as a near-monopoly processor and exporter while leaving room for domestic competitors and to facilitate new entrants.

A fundamental principle was open entry and exit to and from the co-operative for dairy farmers, many of whom have chosen to leave and contract their milk supply to other processors.

Fonterra's milk market share is down to 82% and approaching the 80% threshold at which the DIRA was to expire, leaving the dairy industry to be scrutinised by market competition.

O'Connor's review team is tasked with questions:

- Has the DIRA done its job and should it be rescinded?
- Does Fonterra have effective and sustainable factory gate competition?
- Do farmers have adequate farmgate competition for their milk?
- Has Fonterra evolved in the best interests of farmers and the NZ public, especially in adding value to dairy products?
- How should the dairy industry and its environmental effects be regulated in future?

In a series of weekly articles *Farmers Weekly* will kick off the DIRA review by examining Fonterra's performance, its hybrid co-operative structure, its offshore investments and the volume-to-value strategy pursued by outgoing chief executive Theo Spierings.

First up are arguments by two long-time critics of Fonterra's performance, Geoff Taylor and Arie Dekker.

Next week Fonterra's performance as a co-operative will be examined with some responses from veteran Fonterra senior executive Alex Duncan and in following weeks its case for changes to the DIRA and the Spierings strategy will be looked at.

Rivals are doing better

Hugh Stringleman
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AFTER 17 years under special legislation it is not clear Fonterra has created value for its farmer-shareholders and the New Zealand economy, analyst TDB Advisory says.

"We have not seen evidence of increased returns above the milk price with Fonterra's returns to farmers and shareholders behind those of its now higher-growth and higher-returning competitors," the analysts said in the NZ Dairy Companies Review.

Returns have consistently been below its weighted average cost of capital (WACC) of 8%, indicating the company has failed to provide its shareholders with an adequate risk-adjusted return.

In the second edition of its dairy industry review, TDB said a collective comparison against three other NZ dairy companies now made it possible to evaluate Fonterra's performance overall.

It was done on a number of parameters.

Open Country Dairy was used as the commodities producer, Synlait as the ingredients producer and A2 Milk Company as the consumer products comparison.

"Banded together they provide a comparator for the industry that suggests Fonterra's global volume-into-value strategy has not resulted in additional shareholder value beyond what could have been expected from a NZ-based commodities and ingredients processor," TDB decided.

After projecting earnings and milk market shares ahead to 2020, TDB also argued the three competitors would outperform Fonterra without investing in riskier offshore assets and while paying higher milk prices to farmers.

"Given the lack of evidence of an adequate risk-adjusted return for Fonterra's supplier shareholders it seems reasonable for them to ask how much capital is employed in the consumer and food service segments and whether an improved return could be achieved by separating these segments into a transparent business that has to compete for its farmer capital rather than be protected within the processing co-operative company."

TDB said over the past three years, on average, the combination of OCD and Synlait had earned about the same per kilogram of milksolids as Fonterra but Fonterra had the higher-value consumer and food service business.

When A2 Milk was added, for just the 2016-17 financial year, the combined threesome outperformed Fonterra by 79c/kg MS to 51c.

Moreover, Fonterra's investment into added-value products should show rising revenue per kilogram of milksolids relative to the commodity value but that was not apparent over the past five years.

It was from those comparisons TDB found Fonterra had not fulfilled its promise nor justified the expectations of its special legislation.

The report pointed out the landscape of the NZ dairy sector had changed considerably since the Dairy Industry Restructuring Act (DIRA) was passed in 2001.

During the life of Fonterra total NZ milk production grew from 12b litres annually to a peak of 21.5b in 2015-16.

At formation Fonterra had 96% of the milk supply or 11.5b litres and in the latest season it was estimated to have collected 82% of 21.3b litres, or 17.5b.

Fonterra's increased volume, therefore, was about 6b litres or 52%, over the 17 seasons.

To be able to process all the milk it was obligated to collect under the DIRA and facilitate its drive towards higher-value products and make overseas alliances and purchases, Fonterra spent $15b of new investment.

That compared with about $3b spent by its competitors to be able to process what is expected to be about 4b litres in the new season.

According to company reports and the TDB analysis of cashflow, Synlait spent $475m, OCD $460m (not including the Horotiu plant construction) and Westland $420m.

TDB said the three co-operatives had higher debt ratios than the publicly owned companies, which might be partly because of shareholder-supplier payments ranking behind bank debt for the co-ops.

Fonterra's capital expenditure included offshore investments in Sanlu, China farms and Beingmate, Australia, for whey processing in Europe and the United States, and smaller stakes in Russian and Lithuanian distributors.

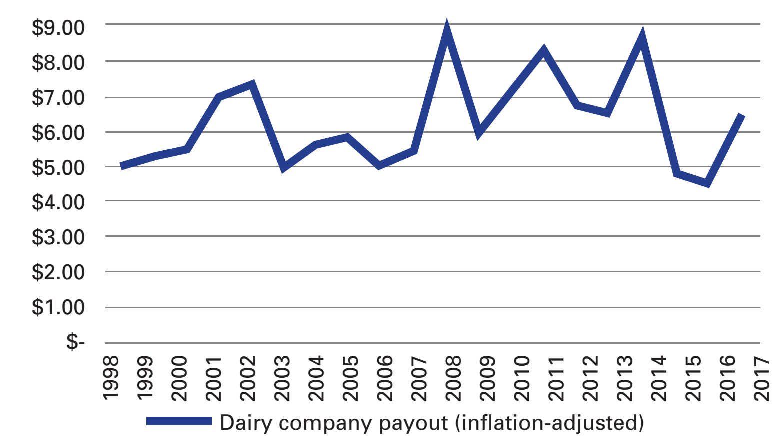
TDB said it is not possible from

Continued next page

HOW MUCH: TDB partner Geoff Taylor finds Fonterra's calculations hard to believe.

The farmers' share

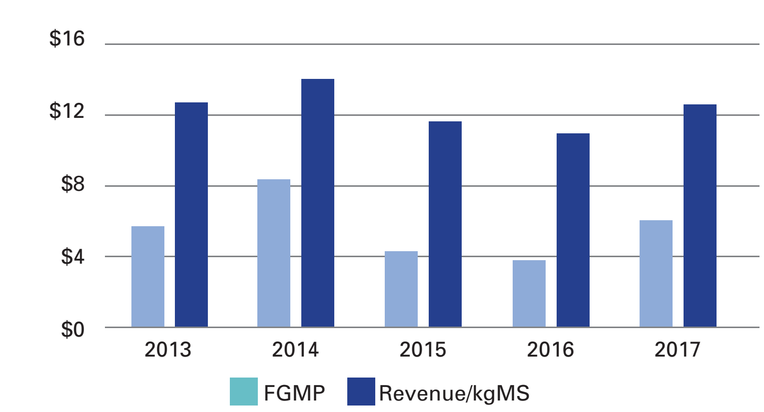
Average dairy company total payout (inflation-adjusted), NZ$/kgMS



Source: Dairy NZ

Payout v return

Revenue/kgMS and FGMP



Review will scrutinise the co-op

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THE review of the Dairy Industry Restructuring Act, after 17 years, is likely to provide an outside look at the effectiveness of Fonterra, First NZ Capital research head Arie Dekker said in a note in January.

He wrote the note following the announcement a review would be done by the incoming Government.

More specifically, the DIRA review would likely look at the success of the New Zealand dairy industry in increasing the value generated from milk production and how farmers' returns have fared over the period.

Dekker said the Government's announcement indicates it will focus on the extent to which farmers, consumers and the NZ economy have benefitted from the regulatory structure.

"And whether the right regulatory, capital and other incentive structures are in place to optimise returns for the NZ economy."

In a note to FNZC clients interested in Fonterra Shareholders Fund units he published a graph of the inflation-adjusted average dairy

company total payout over the past 20 years.

The graph line moved around within a band of $5 to $9/kg without an upward trend as farmers and the Government would have hoped from the performance of Fonterra.

"It is hard to argue that the creation of a national champion in Fonterra has led to a sustained, material upwards impact on the farmgate returns received by farmers over the last 20 years.

"Partly, this reflects the nature of the (commodity based) farmgate milk price that dominates farmer payout.

"But partly it reflects the inability for the NZ industry, particularly on the weight of a doubling of milk volumes over that time, to lift the mix of its output to value-add sufficient to flow through into better co-operative payouts."

Farmers had increased milk supply but not derived any material benefits from the push into value-add, Dekker said.

He suggests there are overlapping concerns in the milk volume versus value issue and environmental matters concerning the dairy industry.

It is premature to suggest an outcome from the DIRA review will be that environmental concerns will lead to a shrinking milk pool.

But Dekker wrote his note before Environment Minister David Parker said that might have to happen in some regions where nutrient limits are adopted.

Through new regulation the Government might try to get the industry to boost value-add rather than just chase more volume.

"The possibility of a shrinking milk pool is not immaterial for Fonterra's embedded asset base and food service and consumer ambitions," Dekker warned.

If Fonterra relies more on its offshore milk pools then access to capital from its shareholder base will be an issue.

The difficulties it faces overseas, especially in Beingmate, are in turn making it seemingly more attractive to supply an independent processor.

EXPERT: Arie Dekker is institutional research head for First NZ Capital. He was previously employed as an equities analyst for Todd Group and Craigs Investment Partners. Dekker has covered Fonterra since 2011.

Fonterra's disclosures to unbundle the investments into ingredients manufacturing, such as milk powder plants, and consumer and food service value-add plants.

The latest annual accounts said consumer and food service earnings made a return of 47.2% on capital, which implied a capital base for that business unit of about $1.3b.

TBD partner Geoff Taylor said

> *If Fonterra was allowed to pay a higher milk price to defend its volumes we would expect a continuation of the premiums being paid by competitors.*
>
> **Geoff Taylor**
> **TDP Advisory**

frankly he found that hard to believe.

"To retain shareholder and investor confidence Fonterra needs to disclose what real returns on assets were generated from the value-add products."

Within the workings of the market regulator concerning the highly efficient processor and the farmgate milk price it was suggested Fonterra would need only $8b of assets to turn all its milk into commodities.

"In the absence of any other unbundling disclosures I am therefore led to assume Fonterra has $10b of assets for consumer and food service products, which means nowhere near 47% return on that capital," Taylor said.

Nor did he believe Fonterra is making a true 11% return on capital overall, which it said in the 2017 results was better than Friesland Campina' s8.8% and Arla's 7.4%.

"They get there by not including brands, goodwill and equity accounted investments (in the capital).

"But if they spent $700m buying into Beingmate and half of that is goodwill, that is my real money and I would like to know what is the true return."

That is why TDB believes the real returns of about 7% are below the WACC.

TDB looked at the revenues of all the dairy companies in relation to the kilograms of milksolids they collected and processed.

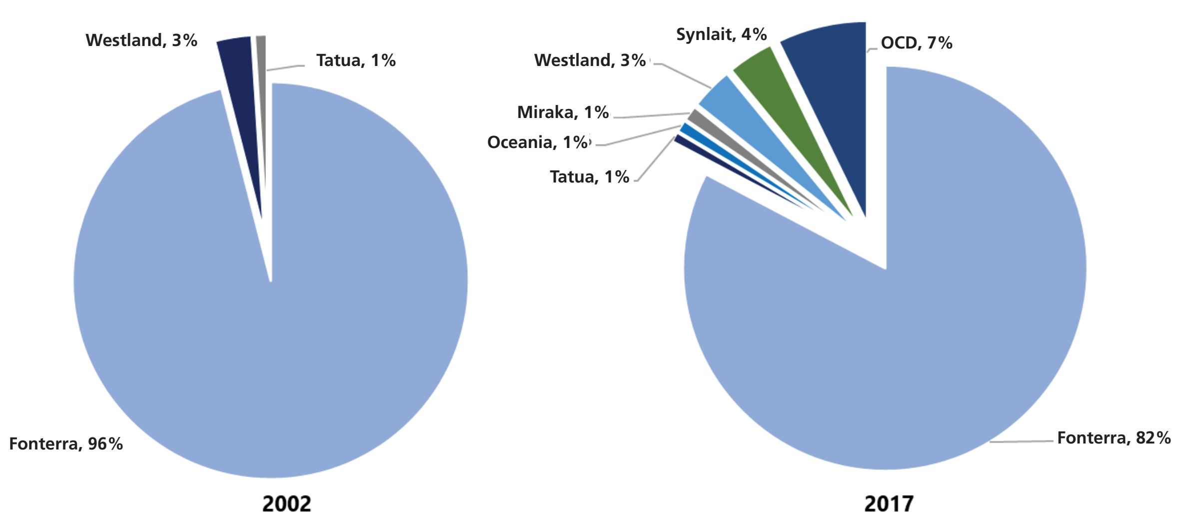
High revenue per unit of milksolids indicated more specialised and higher-value products and so not surprisingly Tatua came out on top with $22.16/kg MS.

Fonterra was next at $12.60, followed by Synlait at $11.69, Westland at $10.60 and OCD on $8.73, which was only 60c ahead of the commodity-only value of $8.13, used as a reference for deriving the farmgate milk price.

Tatua also had the highest fixed assets per kilogram of milksolids processed and it would be very difficult for the other companies to make the investments needed to match Tatua's premium product output.

For example, Fonterra farmers would need to stump up a further $675,000 on top of their current average shareholding of $880,000 a farm.

Slicing the dairy pies



Sources: DairyNZ, company annual reports, TDB Advisory analysis

Tatua had invested almost three times that of OCD per unit of production but Tatua also had operating costs to produce its higher-value products about seven times those of OCD, TDB said.

"When the regulated cost of milk is added it shows just how different OCD, as the low-cost commodity processor, is from the higher-value model adopted by Tatua, with both being profitable."

TDB looked at the milk price differences between companies over the three seasons from 2015 to 2017 and found, on average, Synlait paid 4c/kg more than Fonterra's regulated farmgate milk price, OCD 6c and Miraka, until recently, offered 10c more.

"If Fonterra was allowed to pay a higher milk price to defend its volumes we would expect a continuation of the premiums being paid by competitors."

TDB also expected more longer-term supply agreements, fixed-price contracts and toll processing.

Stranded assets will become a factor in milk pricing and those with spare capacity will fight harder, which will result in greater variation between companies.

The market values of Synlait and OCD, added together, are $15/kg MS processed, compared with Fonterra's $6/share.

That suggested significantly higher forecast growth rates of volume and profitability for Fonterra's competitors.

However, Synlait, OCD and A2 Milk had not paid dividends, opting instead to re-invest their earnings into and so have low debt to asset ratios.

By contrast, Fonterra paid a steady 40c/share, or 6% return on capital.

Geoff Taylor is a director of TDB Advisory, a group of qualified and experienced financial and economic advisors. He left Fonterra in 2002 after being global head of corporate finance and treasury for the NZ Dairy Board and participating in the establishment of Fonterra. He is a former director of other dairy companies and has provided advice to those companies.

The statement of independence attached to the TDB Dairy Companies Review fully discloses the extent to which TDB and its directors are involved in the dairy industry. It also said TDB has no conflict of interest that could affect its ability to provide an unbiased report.

The report was not commissioned or sponsored by any entity and no dairy company had any input. The dairy company information is all publicly available.