Performing as a co-op should

Neal Wallace
neal.wallace@nzx.com

FONTERRA gets a pass mark from industry observers for its performance as a co-operatively-owned business.

But they warn it cannot rest on its laurels given challenges connecting with 10,500 owners and plans for further investment in added-value and consumer products.

Fonterra Shareholder's Council chairman Duncan Coull said Fonterra has performed as a co-operative should. It is owned and democratically controlled by members, it serves its members, returns surpluses to members and strives to operate profitably.

"Fonterra has performed but it is not perfect. But that is the reality of business."

Shareholders should celebrate Fonterra and New Zealand's 148-year co-operative ownership of the dairy sector, which outperforms dairy industries overseas.

Fonterra members have safeguards such as an independently assessed milk price and separate governance and representation, protection not available to dairy farmers elsewhere.

But Fonterra can do better and in two areas in particular, he said.

The tough economic conditions of the last three to four years have eroded shareholder belief and purpose in Fonterra.

"We need to re-establish purpose and vision in the industry and the co-operative so we stay relevant for current and future generations."

Coull said the connection between shareholders and the co-operative needs to be more than a blue sign with a supplier number at the gate but something that unites shareholders behind a clear purpose.

It is what gets people out of bed in the morning, the legacy they want to leave and a sense of belonging.

This connection needs to be attractive to future generations, a return to what the small, local co-operatives had before they started merging.

"It needs to be more than milk price and dividend," he said.

Addressing the sense of connection could also stem Fonterra's milk supply leaking to competitors.

Another issue to be addressed is the need for greater flexibility to help those entering and exiting the co-operative.

A sustained period of growth has provided shareholders with the ability to financially leverage their businesses but created entry and exit issues for members.

"You could say this is a challenge but I think it is an opportunity. The reason we have been around for 148 years is that we have always had challenges but we have had discussions and found solutions."

> *Co-operatives do provide functions well beyond their financial performance of their members.*
>
> **Lisa Callagher**
> Auckland University

Finology principal Alex Duncan, who previously worked in corporate finance at Fonterra and implemented Trading Among Farmers, said the co-operative has performed well given the demands made of it.

Fonterra is a much superior alternative to the option being considered of two competing co-operatives, he said.

It has had to deal with growing and substantial milk flows while also being what he calls the grid operator for the industry, providing milk to competitors and accepting milk from any shareholder.

That obliged the co-operative to fund and have processing capacity ready ahead of new milk arriving.

Duncan said Fonterra members have benefited from intentional measures to be transparent.

The establishment of TAF was in response to fears of large-scale share redemption but also to help establish a share price.

Similarly, the 2008 launch of Global Dairy Trade was a transparent process to help determine a milk price.

Both were successfully tested in the 2013 botulism scare and record prices for whole milk powder in 2014.

"They were tested and I think survived that test."

Shareholders require a high payout to earnings ratio that helps maintain Fonterra's financial and processing discipline, he said.

That requirement includes any exceptional profits to be reflected in the high milk price.

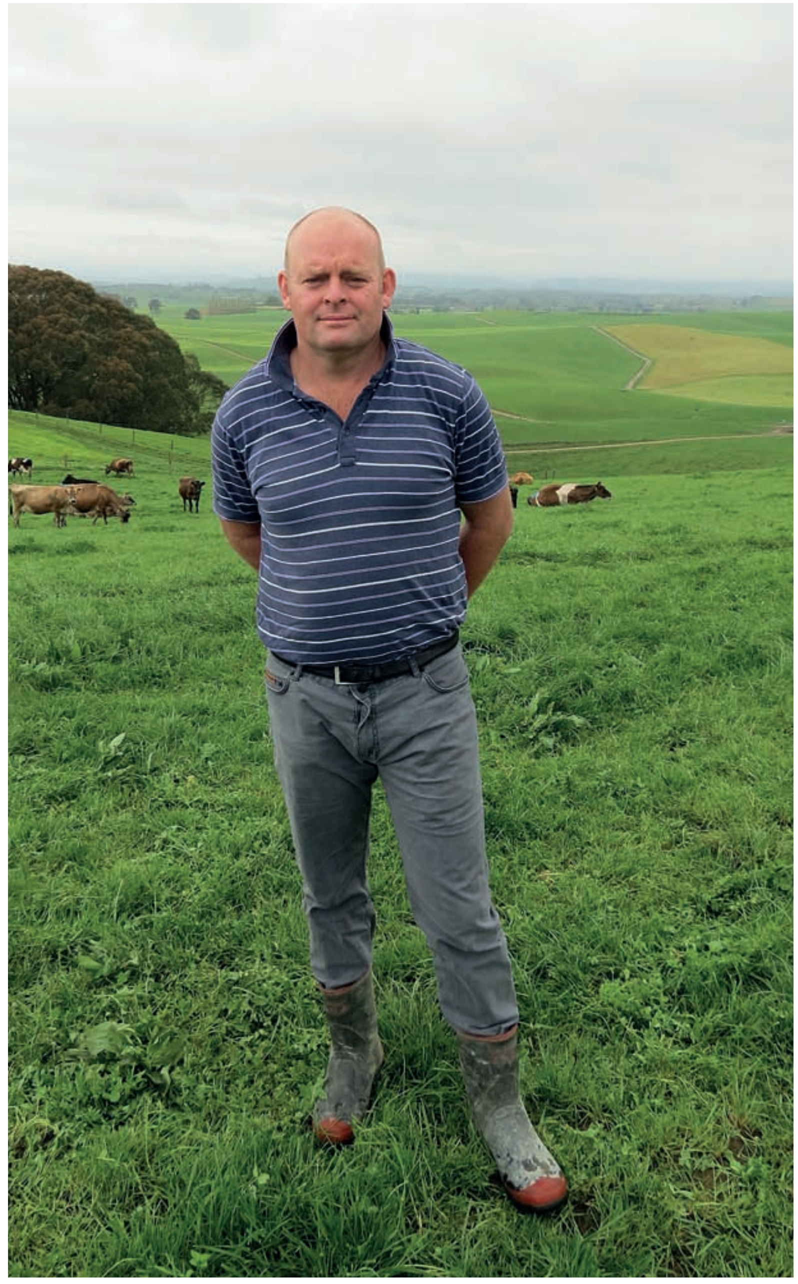
Duncan believes some Fonterra shareholders could start to question the extent and nature of owning shares in companies such as Soprole in Chile and China's Beingmate.

Auckland University business school senior lecturer Lisa Callagher, who has studied co-operatives, said Fonterra has performed financially, socially and environmentally.

She believes it will have a much greater role environmentally but is already active helping members, such as meeting Water Accord expectations.

"Co-operatives do provide functions well beyond their financial performance of their members."

Socially, Fonterra's recent Richie McCaw television advertisements are an acknowledgement the co-operative is not connecting with members as well as it had done previously.



WAVELENGTH: Fonterra has performed well but needs to strengthen its connection with shareholders to re-establish purpose and vision, Shareholders' Council chairman Duncan Coull says.

The milk in schools programme is another example of it performing a socially responsible role.

Financially, Fonterra has performed reasonably well given the international pressures on export dairy prices.

Callagher said being a co-operative will not hinder Fonterra's pursuit of growth, pushing more product in to the value-added space or investing offshore.

The challenge is getting consensus from 10,500 individual members who have diverse risk appetite for such investments.

Co-operative Business NZ chief executive Craig Presland said Fonterra's stock exchange listing of supplier investment shares is a successful way of raising capital while also retaining the criteria of being a co-operative.

Flexibility gives Fonterra edge

Hugh Stringleman
hugh.stringleman@nzx.com

FONTERRA has a silver lining in a cloudy forecast for a declining share of milk collections, former employee Alex Duncan says.

First, Fonterra has an unmatched ability to produce the most profitable basket of dairy products from a bucket of milk.

Historically, when processing volumes approached capacity Fonterra had to produce whatever it could, whether profitable or not.

Second, the co-operative is no longer faced with huge extra investments in ingredients capacity simply to deal with increasing peak milk production.

That will free up Fonterra to invest retentions in complementary value-add processing.

Duncan was a strategy and economics general manager at Fonterra. He was at the centre of market development for over a decade, initiating Global Dairy Trade and conceiving Trading Among Farmers. He is now a principal of Finology, a financial economics firm.

"Co-operatives are like bicycles … they fall over when you stop pedalling," Duncan said as he made the case for Fonterra continuing to lead development of global dairy markets.

Development will be not only in physical product markets but also related markets of financial contracts for dairy products.

"Deeper physical and financial derivative markets will be of particular value for Fonterra given its unmatched product mix flexibility and likely significant ongoing price volatility."

In volatile markets having wider options in processing increases the value of the co-operative's manufacturing assets compared with smaller processors that have less mix flexibility.

Duncan noted the fall of Fonterra's milk market share to 82% and forecast static milk flows need not therefore be an impediment, particularly with its capacity expansion to more than 90 million litres a day at the peak.

Fonterra's regulatory context is now being examined by a Government review of the Dairy Industry Restructuring Act, to be done by the Primary Industries Ministry.

In the 17th year of what was intended to be temporary regulation, it is even more apparent to Duncan the domestic dairy market has the dynamism to mature and take on a life of its own with much less reliance on regulation.

New domestic milk processors are emerging and market participants other than milk processors and domestic food producers are a strong influence.

What he calls the Fonterra experiment has nurtured innovative development across the dairy sector while facilitating substantial growth in New Zealand dairy farming since 2001.

"Due to the highly seasonal milk production this is not the natural place to convert every litre of milk into consumer products or specialty ingredients.

"It is highly cyclical because milk flows when grass grows and the predominantly pasture-based system means that farmers typically incur among the

Continued next page

lowest costs per unit of milk production globally."

Milk production in June 2017 was only 6% of that in October.

"Such a supply profile isn't a viable platform to build a consumer or specialty business that can profitably use every litre that arrives at the factory gate," Duncan said.

"Besides, as noted in the recent report by TDB, billions of dollars would have been required to build a consumer and specialty ingredients business to absorb all milk supplied by farmers.

"This would have been high risk and difficult to finance."

Duncan considers many farmers regard Fonterra as an extension of their farms, with the co-operative expected to collect and process milk as volumes grow. Not having sufficient capacity to process milk simply isn't acceptable.

The vibrant farmgate market environment puts the onus on those wanting to make the case for continued farmgate regulation, he said.

"What is the purpose of the open entry and exit obligations on Fonterra now that farmers in most areas have choices of processor?"

> *Setting a single, annual milk price may not be optimal given continuing volatility in commodity prices.*
>
> **Alex Duncan**
> Finology

He thinks Fonterra's obligation to take all milk has been an aggravation in a small number of cases rather than a major impediment.

"Fonterra would largely have evolved the way it did regardless of the DIRA obligations to serve the needs of its farmer-shareholders as they expanded their milk production. The co-operative will continue to compete strongly for milk, as it should.

"But why risk imposing a cost on Fonterra alone when competition has intensified and barriers to entry appear to be low?"

Duncan notes a possible outcome of the regulatory

UNFAIR: Dairy regulations should not impose a cost on Fonterra alone when competition has intensified and barriers to entry appear to be low, Finology consultant Alex Duncan says.

review is a revamp of onfarm environmental and other obligations.

"While that may be appropriate, any new obligations should be neutral across all suppliers, not just those who supply Fonterra."

The competitive market for milk here and in offshore markets will require Fonterra to be more nimble.

Farmers can already supply Fonterra on contract without being shareholders.

But if and when they buy shares, should they be compelled to invest in offshore businesses, particularly if they don't have a strong synergy with NZ operations?

"Fonterra's market share of just over 80% suggests that a substantial proportion of farmers consider they don't need exposure to downstream investments to operate a profitable farming business at prevailing farmgate milk prices."

Since 2012 Fonterra has typically distributed about 80% of earnings as dividends.

"Distributions of this magnitude imply that Fonterra is perceived by its shareholders to be more akin to a cash-generating infrastructure asset than a downstream growth-oriented entity."

Duncan also notes potential merit in introducing more flexibility in how the milk price is structured.

"Setting a single, annual milk price may not be optimal given continuing volatility in commodity prices.

"For example, an annual milk price may induce farmers to increase or reduce production late in a season, contrary to prevailing market signals.

"Fonterra already pays less for milk at peak production than shoulder milk.

"It also pays premiums to induce higher seasonal production in certain areas to support value-added production or for differing milk attributes such as organic.

"But explicitly setting more than one milk price within a season is likely to convey better signals and increase long-term returns.

"Regardless of what I or anyone else suggests, in a well-regulated and increasingly competitive market for milk Fonterra's shareholders and board should be left to refine the co-operative's operations and strategy."

The temptation for politicians or outsiders to use DIRA or regulation to displace the role of shareholder-owners should be firmly resisted, he said.

MORE: EMERSON P28

CONNECTED: Finology consultant Alex Duncan says famers regard Fonterra as an extension of their farms.