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Assessment of Fonterra's performance after 12 months

By Tony Baldwin

12 months have passed since dairy leaders and the Government agreed on a mega-merger package. Let's take a quick look at Fonterra's scorecard after one year. First the positive side of the ledger.

Fonterra has kept milk supplies flowing and factories working. Except for a few bumps in supplier relations, Fonterra has apparently managed the merger of Kiwi Dairy and NZ Dairy Group at an operational level in a relatively seamless manner. To integrate the operations of NZ's two largest dairy co-ops without major disruption to suppliers or customers is no mean feat.

On the management side, Fonterra has rationalised the co-ops' staff structures. Various functions in three separate head offices had to be collapsed into one. Several experienced people sought the same job. Some redundancy are reported to have been handled in rather clumsy way. And the services of some key people, who Fonterra wanted to retain on contract, have been lost. However, it was always going to be a big challenge for Fonterra to hold on to good people and keep morale up.

Fonterra has raised new capital, including $200m from capital notes (bonds), which are now listed on the Stock Exchange, and $120m from the sale of its shares in NZ Dairy Foods. It has built war-chest for the next year or so. No doubt, this will be enlarged by increased borrowings.

Another improvement is that, for the first time ever, dairy farmers can realise a 'fair value' for their shares. This is still controversial. Historically, co-op shares have been valued at their original issue price. The 'fair value' process will help farmers measure any increase or decrease in the value of their investment.

Finally on the positive side, Fonterra says it is on-track to deliver $320m in efficiency gains from merging our two largest co-ops.

On the negative side of the ledger, Fonterra's directors have yet to establish their strategic objectives or an overall business plan. For are now, they are operating in a vacuum, making large decisions on an ad-hoc basis. The company's has set up 'Project Galileo' to formulate its business strategy. McKinsey & Co have been commission again to lead the project.

For now, Fonterra's aims are confused. On the one hand, it is a traditional closed dairy co-operative processing milk supplied by its shareholders. On the other hand, some managers view it as an international capital investor. Others see it as becoming a diversified multinational dairy food business. Yet others want it to become a world leader in high-margin biotech and pharmaceutical products. What are Fonterra's goals?

Another problem is that Fonterra's shareholders have not been given a choice. Despite the absence of a clear strategy, Fonterra's directors have recently committed NZ resources to processing and selling milk produced in other countries, including Mexico, South America and India. NZ dairy farmers have not been given a choice about whether they wish to invest in riskier overseas ventures processing foreign milk. Fonterra is using their capital without asking them.

A serious weakness in Fonterra is that its board of directors is not up to scratch. The board is too big and lacks the expertise, experience and balance required to lead Fonterra, particularly in international marketing and investment. 10 of the 12 directors are mainly expert in milk production. Few have the experience and know how to assess properly costs, risk and returns of large overseas business opportunities. Too many directors are likely to feel out of their depth and therefore abide by the industry's tradition of generally accepting advice from managers and consultants.

Fonterra's directors are overly dependent on consultants. Unfortunately, some of their key consultants have diluted their advice in the face of political tensions within Fonterra or among farmers. Fonterra is surrounded by too many people eyeing their next Fonterra contract, with the result that serious alternatives are sometimes not adequately considered and recommendations are not properly tested by the board.

To add to these difficulties, Fonterra is not adequately monitored. By way of background, a key aim in monitoring any business is to continually assess, on behalf of shareholders, the value impacts of managers' decisions. In a large company, this task is performed by three different groups: firstly, the directors; secondly, large or cornerstone shareholders; and thirdly, external analysts and financial institutions acting on behalf of existing and potential investors.

Fonterra is deficient at each level. Its board is relatively inexperienced and inexpert on these matters. Fonterra has no cornerstone shareholder. Its shares are not listed, so none of the of normal market institutions assess the value effects of key business decisions by Fonterra's managers.

Fonterra's Shareholders Council is not likely to be effective either. While the Council has established a performance review committee, in practice it is completely beholden to Fonterra. So far, Fonterra has provided it with limited useful or timely information. The Council is likely to become a staging-post for farmers aspiring to be directors. It may also become a forum for wider industry politics.

To add to this, Fonterra cannot achieve its growth goals in its current form. Among other things, it will not have sufficient capital. Share capital beyond NZ dairy farmers will be required. For years, leaders have lived in deep fear of raising this issue. It breaches the industry's two sacred rules, which are that no one except suppliers of NZ milk may hold shares, and that shares must be held in exact proportion to milk supplied. These semi-religious covenants are not sustainable if the industry is serious about achieving its growth targets.

Fonterra cannot deliver both exclusive ownership for NZ dairy farmers *and* massive growth. For now, this fundamental conflict has been swept under the carpet; but it will resurface, sooner rather than later.

In its current form, Fonterra will not contribute well to the Government's key goal of 'economic transformation'. Resources will continue to be misallocated to increasing milk production rather than responding to customer demands in the most profitable way possible.

To remedy this most fundamental of problems, elements of the industry's 1999 reform plan need to be implemented, in particular carrying on the non-commodity businesses under a normal company with tradable shares, outside capital and dividends separated from milk payments to farmers. Also, revenues from sales in quota markets need to be separated so they are not used to camouflage poor performance in other areas.

A final problem that casts a shadow over Fonterra's first-year report card is whether CEO Craig Norgate knew, directly or indirectly, about the Kiwi Dairy's tricky scheme to export in competition to the Dairy Board, which was of course unlawful. Official investigations and industry doubts may continue to haunt Mr Norgate's tenure.

As for Fonterra's recently announced alliance with Nestle, it is not clear at this stage whether it will increase or decrease the wealth of Fonterra's shareholders. Information released to date is simply insufficient to determine its likely prospects. Even the Shareholders Council know very little about the expected costs, risks and returns. So far, it appears that Fonterra is to buy and operate Nestle's milk processing factories in the Americas.

On some scales, Fonterra sneaks into the top 10 dairy businesses in the world. However, it is still largely a commodity business and is half the size of its leading competitors. In the higher-value consumer end of the business, where the real money is made, Fonterra does not feature.

The burning question, therefore, is where does Fonterra want to be in five years and how will it get there? The future of the NZ economy as a whole is closely tied to Fonterra's response to these two questions. Unfortunately, they were swept under the carpet last year in the industry's campaign win Government and farmer approval of Fonterra.

We cannot afford to keep trying to hide these key issues.

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