Dairy giant slow to deliver

Column by

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A year ago, Fonterra's leaders promised dairy farmers the world. 12 months later, in their first annual report, it is apparent that the directors are finding it hard to deliver.

Within the layers of PR gloss and hype, two figures stand out.

First, the gap between what Fonterra should have paid and what it actually paid farmers for milk. According to Standard & Poors' benchmarking, if Fonterra was efficient it would have paid farmers $5.45 per kgm. It actually paid $5.06. This 39 cents gap equates to $430m. Put plainly, Fonterra is not efficient - it is wasting $430m per year.

Another critical figure is the $525m reduction in expected cash flows from operating activities. A fall of this magnitude is serious. The annual report fails to explain adequately why it happened and what remedial action is to be taken.

Read together, these two pieces of information point to deeper weaknesses in Fonterra's core commodity operations. Fonterra's leaders would be unwise to try and dismiss it as an unavoidable consequence of falling commodity prices.

The question now is whether John Roadley and his board have the insight and strength to act. My own impression is that Mr Roadley does not. He prefers to camouflage problems with PR rhetoric. This is often a sign that a person is out of their depth.

Three other omissions in the annual report are worrying.

Fonterra elected not to disclose performance in product categories. As a result, shareholders are left with not much idea of the business' strengths and weaknesses. Compared to best practice disclosure standards set by leading competitors, Fonterra's business remains a relatively amorphous blob to readers of its annual report.

Fonterra has also failed to provide any meaningful information on the expected costs, risks and benefits of its much-heralded new joint ventures in India, Europe and the Americas. We continue to get PR hype, but no substance.

Another important omission is a business strategy. Where is Fonterra heading and how will it get there? When top commercial director, Mike Smith, resigned earlier this year citing poor corporate governance, the company promised to sort out its lack of strategic direction.

In 1999, leaders justified the dairy mega-merger to the government as the best way to grow wealth for farmers and NZ's wider economy. Their 10-year goal was to raise an extra $12 billion in capital, grow revenues by 15% each year (from $10 to $40 billion pa) and achieve a return on total gross assets of 15% every year, mainly by growing high value biotech and consumer products.

What happened to this strategy? At best, it was rhetoric. At worst, it was a front (a very expensive one at that). Certainly, few farmers swallowed it. Curious that the government did. I have even heard directors say it was largely wallpaper. Such a grand strategy is simply not possible under Fonterra's current capital structure. Ironically, this is a source of comfort for many dairy farmers.

Nonetheless, Fonterra's CEO, Craig Norgate, continues to say that Fonterra's plan is "to launch an aggressive strategy of acquisitions and joint ventures, to earn the status of one of the world's leading multinational dairy companies."

But big is not necessarily better. John Roadley was wrong last year to dismiss the role of small, high-margin dairy businesses like Tatua in the brave new world of global retailers.

The worry is that Mr Roadley is still in no man's land, distracted by vacuous platitudes that litter his report, such as `protecting our heritage', `the Fonterra Way' and `capturing the value of milk'.

In reality, Fonterra is a low-margin commodity business, driven by its statutory obligation to process ever increasing volumes of milk from farmers. Not surprisingly, Fonterra has developed strong skills in drying huge amounts of raw milk and shipping it overseas.

However, in the world of dairy foods, Fonterra is neither large nor small. It is not nimble or powerful. Its fortunes fluctuate with commodity prices. In essence, Fonterra `captures the value of grass'.

By contrast, customers drive Tatua. It supplies products for which consumers pay high margins. It is much less affected by lower commodity prices. Tatua can properly claim to `captures the value of milk'.

After 12 months of operations, has Fonterra achieved anything that could not have been delivered under the old single-desk system? On the face of it, the answer is no.

Fonterra's main achievements to date have been better internal benchmarking, some efficiencies gains at the factory level, selling its share of NZ Dairy Foods, entering into various joint ventures, improving exit and entry pricing for farmers, processing more milk than ever before and making a record payout to farmers on the back of high commodity prices and a low exchange rate.

Could this have been achieved under the previous regime? Yes, almost all of it.

So why the mega-merger? In essence, it removed uncertainty about deregulation. The guillotine had been hanging over the single desk for some time, but no one knew when and how it would drop. Given that business hates uncertainty, the mega-merger provided resolution: a statutory monopoly was replaced by a government-sanctioned commercial monopoly which looks likely to remain in place for the foreseeable future.

The question now is whether Fonterra can deliver on its key promise to become a platform for market innovation and wealth-creation. Will it make the necessary efficiency gains? Will industry resources that are poorly used be released for other risk-takers to extract value?

With such a long culture of control and insularity, the best answer an optimist could give is `slowly - very slowly'. Too slowly if NZ is to lift its game.

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