REPLY TO LETTER FROM WILLEM JONKERS TO 'THE DAIRYMAN"

Mr Jonkers describes Fonterra's bid for National Foods as a "merger" involving a "negotiation process", which he says I don't understand. Unfortunately, it is Mr Jonkers who misunderstands the commercial nature of the deal.

It is *not* a merger, like two dairy co-ops combining, where the terms and conditions are negotiated between two boards. The decision to sell National Foods to Fonterra will *not* be made by a majority vote of National Foods shareholders, as it would be in a dairy co-op merger.

This is a hostile takeover of a listed public company. It is governed by Australian Stock Exchange rules and companies legislation. The majority of National Foods' shareholders are commercial investors, not suppliers. Each National Foods shareholder will decide whether to sell his or her shares on an individual basis directly to Fonterra. They will receive advice from a range of outside analysts and advisers. Unlike a merger, they will have no vote in the combined company if Fonterra's takeover succeeds.

Mr Jonkers claims that most dairy farmers support Fonterra buying National Foods. I have not suggested otherwise.

It is clear, however, that most Fonterra shareholders are relatively uninformed of the likely value impacts this takeover will have on their investment in Fonterra. Unlike National Foods' shareholders, they do not have a variety of independent analysts evaluating the expected discounted cashflows. There is no market for Fonterra's shares and therefore no way to gauge the views of others on whether future returns are likely to increase or decrease. And to top it off, unwilling farmers have no choice but to invest in National Foods, unless they cease supplying Fonterra.

All this adds up to weak safeguards for shareholders and inadequate commercial pressure on Fonterra's directors.

Surprisingly, Mr Jonkers disagrees that dairy co-ops are production-driven. He implies that the NZ industry has been successful in "making products which its customers and consumers want". The facts are strongly against him.

Traditional co-ops are, by their very nature, set up to serve suppliers. As Dr Adrie Zwanenberg puts it: "The dairy cooperative mission must be *entirely* orientated towards the problems of the dairy farm business"[1]. Market-demand and customer-needs are some way down the ladder.

Other leading co-op proponents like Van Bekkum and Nilsson[2] agree that co-operatives' traditional strategy is to maximise volume. It is widely accepted that the Dairy Board was product-led. Warren Larsen concedes that the Dairy Board was simply "finding a home" for the 100% increase in production over the last decade. Many other expert reports make the same point.

Fonterra's consumer arm, NZ Milk, was set up in the early 1990s by the Dairy Board to "develop high value branded or specialised products and take them into positions of market leadership"[3]. Despite the PR hype, profits as a percentage of revenue were negative for each 'value added' product category, except for powders.

Promar International[4] boiled it down as follows: "Cooperative processors concentrate on commodity products (low value/low margin end), while corporate companies (Kraft, Nestle and others) have a much stronger market presence in added value consumer foods. This reflects stakeholder preferences: co-ops are required to shift large volumes of milk for their supplier shareholders, while corporate processors are concerned with maximising value, not necessarily volume".

In short, it is hard for a traditional supplier co-operative to give priority to the demands of consumers over the demands of suppliers.

Mr Jonkers also claims that "the costs of supporting NZ Milk's consumer brands will significantly decrease". The view of industry's leaders and their advisers over recent years is the opposite.

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1 Dr Adrie Zwanenberg is a chief adviser with Rabobank and strong advocate of cooperatives. This extract is taken from his 1997 Ph.D thesis: "European Dairy Co-operatives Developing New Strategies"

2 Onno-Frank van Bekkum is Senior Researcher at the Netherlands Institute for Cooperative Entrepreneurship, University of Nyenrode. Jerker Nilsson is Professor of Cooperative Business Administration at the Swedish University of Agricultural Sciences

3 From Warren Larsen in a speech to a 1997 conference

4 Promar International is a UK-based firm that specialises in research and consultancy in the agricultural, agri-food, and branded food & drink sectors in the UK and worldwide. Promar prepared a report for the NZ Ministry of Agriculture and Forestry in 2001 on the proposal to form Fonterra

In June 04, Andrew Ferrier hinted at the need for more capital to fund consumer activities: "While Fonterra can fund the immediate needs of the cornerstone activities and current options within our existing balance sheet, as the business evolves this may not always be the case…Any inability to access sufficient equity could undermine our ability to realise the full potential of our value-added operations".

Craig Norgate said something similar in 2002.

The fact is that growing consumer brands and other high margin products will require more capital, not less. Many industry reports confirm this. If Fonterra's full potential is to be realised, it is unlikely that current shareholders will be able to provide all of it.

One point on which I agree with Mr Jonkers is that dairy farmers are very opposed to outside capital. As Dr Murray Fulton[5] points out, their opposition is deeply ideological. It is not based on commercial experience or objective analysis.

Mr Jonkers may ask, what right does an outsider like me have to comment when I'm not a shareholder? The answer is, because Fonterra was created by special legislation. Parliament allowed it to be a near-monopoly, when any other company would have had to prove its business case to the Commerce Commission.

So while Fonterra may be owned exclusively by dairy farmers, its performance (or lack of it) is a public policy issue 'owned' by the people of New Zealand.

In relation to the National Foods takeover, the question Mr Jonkers should be asking is, will it deliver returns sufficient to cover the risk-adjusted opportunity cost of the capital to be invested? I wonder if he has considered this core issue.

ENDS

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[5] Dr Fulton is Director of the Centre for the Study of Cooperatives, University of Saskatchewan: "At its most basic level, cooperative ideology is a belief that doing business with an organisation owned and controlled by farmers is preferable to doing business with an organisation owned by external investors" – extract taken from his 2003 paper, "Traditional v New Generation Cooperatives"