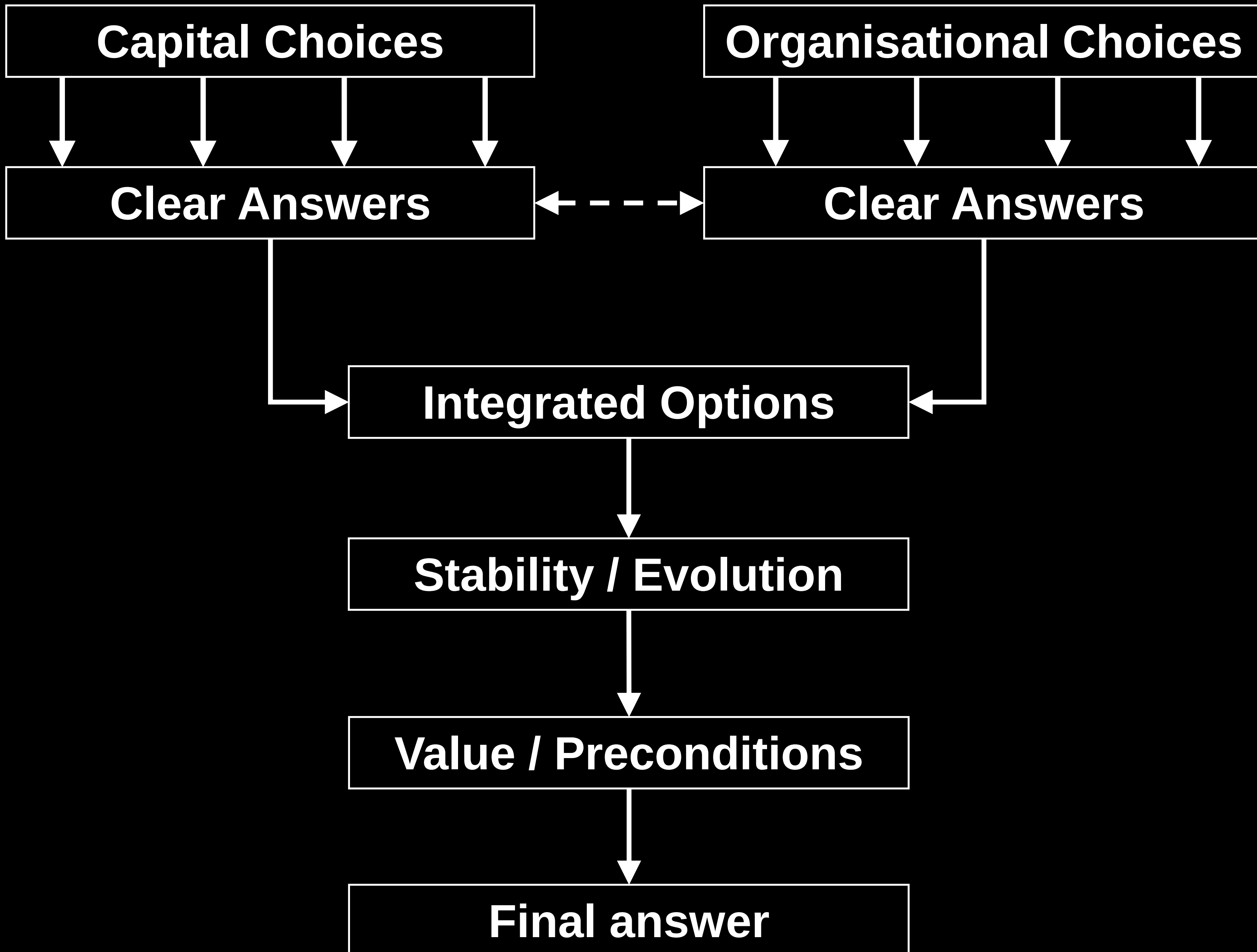
Dairy Industry Structure Project

Presentation to Select Committee

10 August 1999


Capital Choices
Organisational Choices
Clear Answers
Clear Answers
Integrated Options
Stability / Evolution
Value / Preconditions
Final answer

FOUR CAPITAL / OWNERSHIP DESIGN CHOICES

Current situation
Organisational trends

Capital/Ownership Design Choices

External equity	**Internal equity**
Corporate governance structure	**Co-operative governance structure**
Ownership linked to supply	**Ownership delinked from supply**
Differentiated farmer payouts across NZ	**Uniform farmer payouts across NZ**

FOUR ORGANISATION DESIGN CHOICES

Current situation
Organisational trends

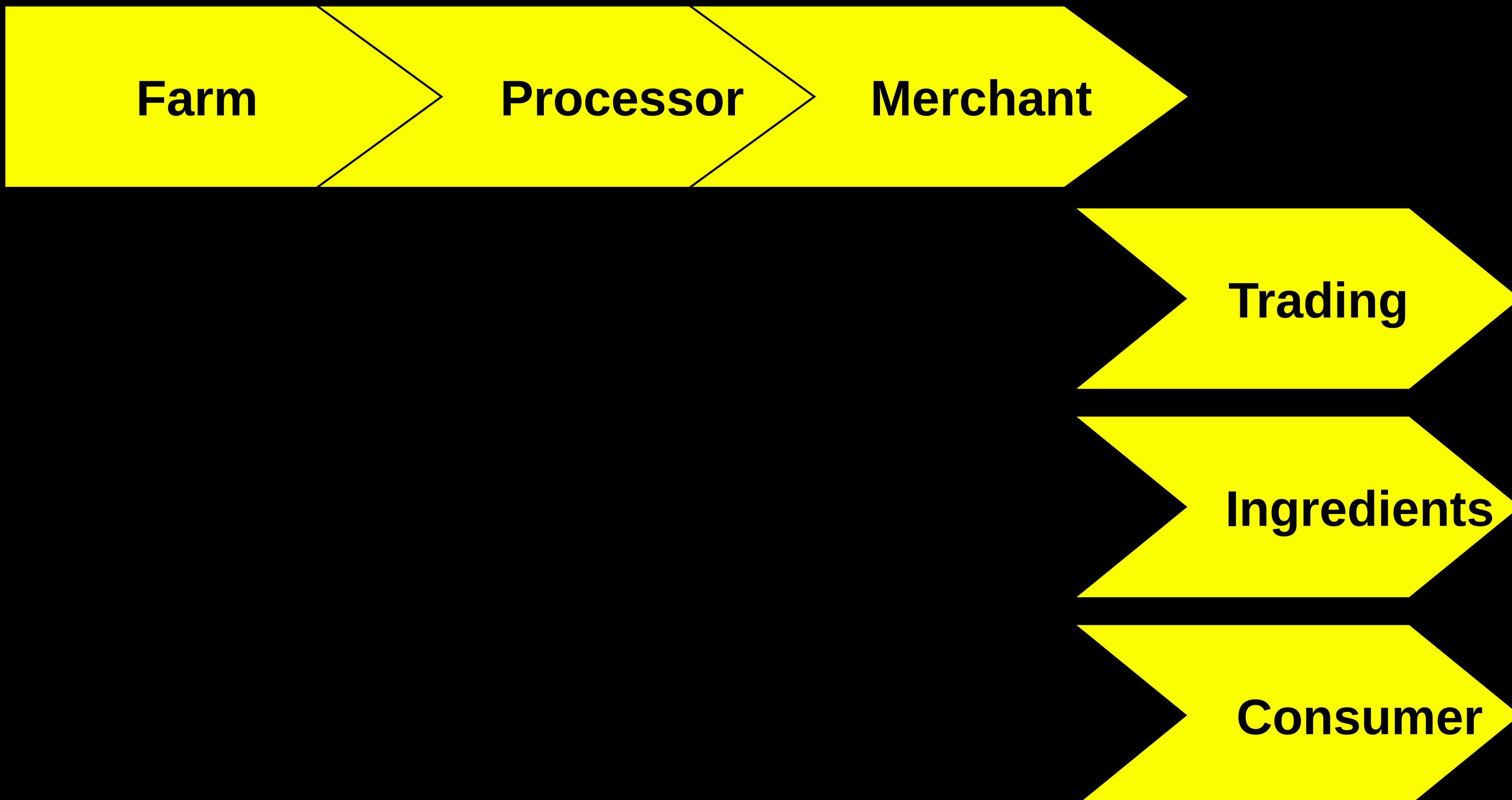
Organisation Design Choices

Multiple marketers	**Single Marketer**
Multiple manufacturers	**Single manufacturer**
Vertically aligned	**Horizontally aligned**
Atomised organisation	**Centralised organisation**

TWO KEY PRINCIPLES

- **Maintaining Farmers' control**
- **Providing Farmers with choice**

SUPPLY CHAIN STRUCTURE - SIMPLIFIED



ASSESSING BARGAINING POWER

Assessing the market structure

Number/concentration of sellers ↓ / Number/concentration of buyers →	One	Few	Many
One	High trading risk	High trading risk	Sellers dominate
Few	High trading risk	High trading risk	Sellers dominate
Many	Buyers dominate	Buyers dominate	No-one dominates

- **Bargaining power**
  - **number of players**
  - **variable supply**
  - **perishable milk**
  - **asset specificity**

TRANSFER PRICE

Farm Processor Merchant

Trading

Ingredients

- Clear internal transfer price

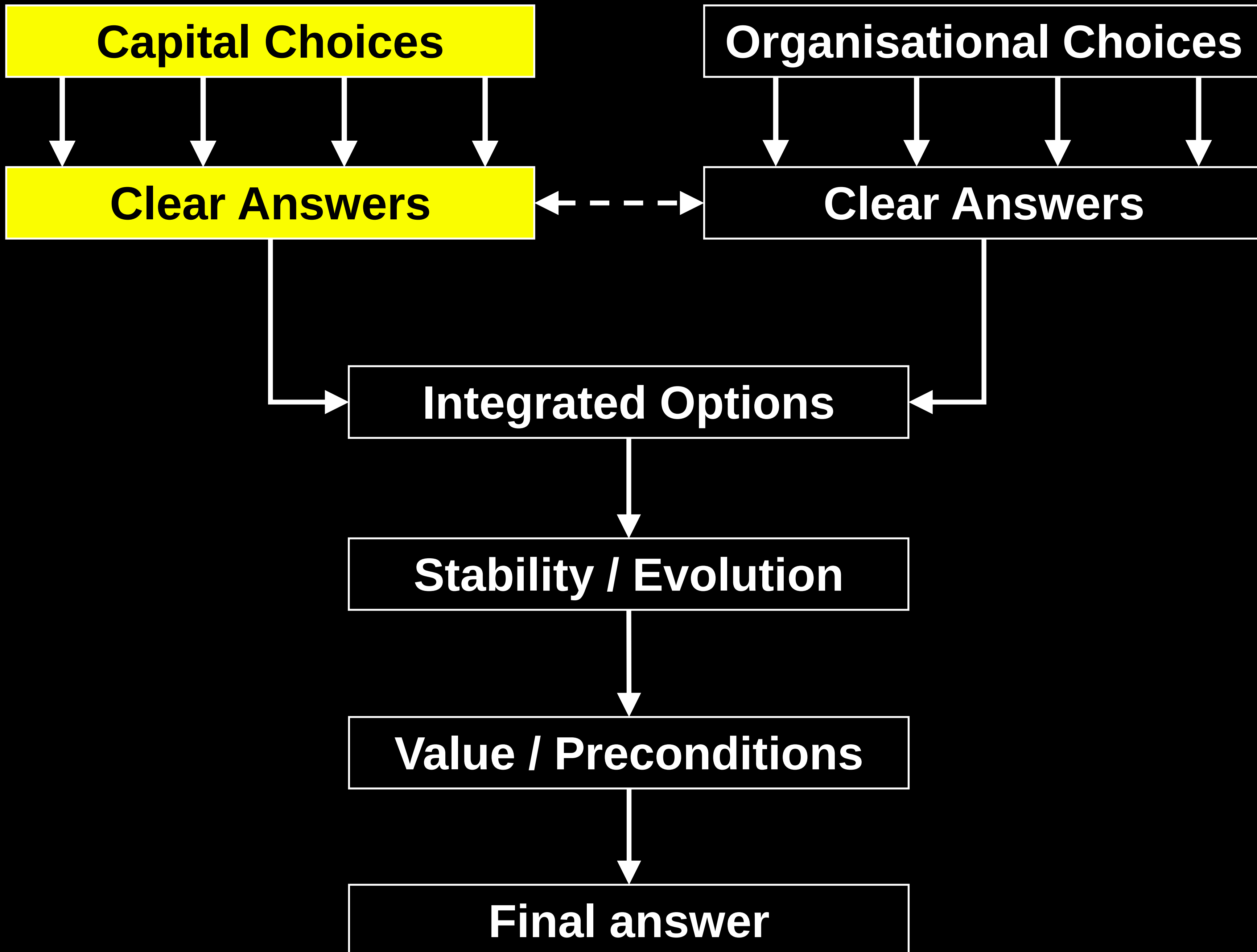
Ingredients slivers

- Clear transfer price

Consumer

- Clear transfer price

Integration is not required for ingredients slivers and consumer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CAPITAL / OWNERSHIP QUESTIONS

External / Internal equity	• **Do we need to structure parts of the business to provide for external equity?**
Corporate vs co-operative	• **Should the Industry maintain a co-operative ownership structure for all parts of the business?**
Ownership Linked/ Delinked to Supply	• **Should returns from downstream investments be delinked from supply?**
Differentiated/ Uniform Payout	• **Should the Industry have the ability to differentiate payout?**

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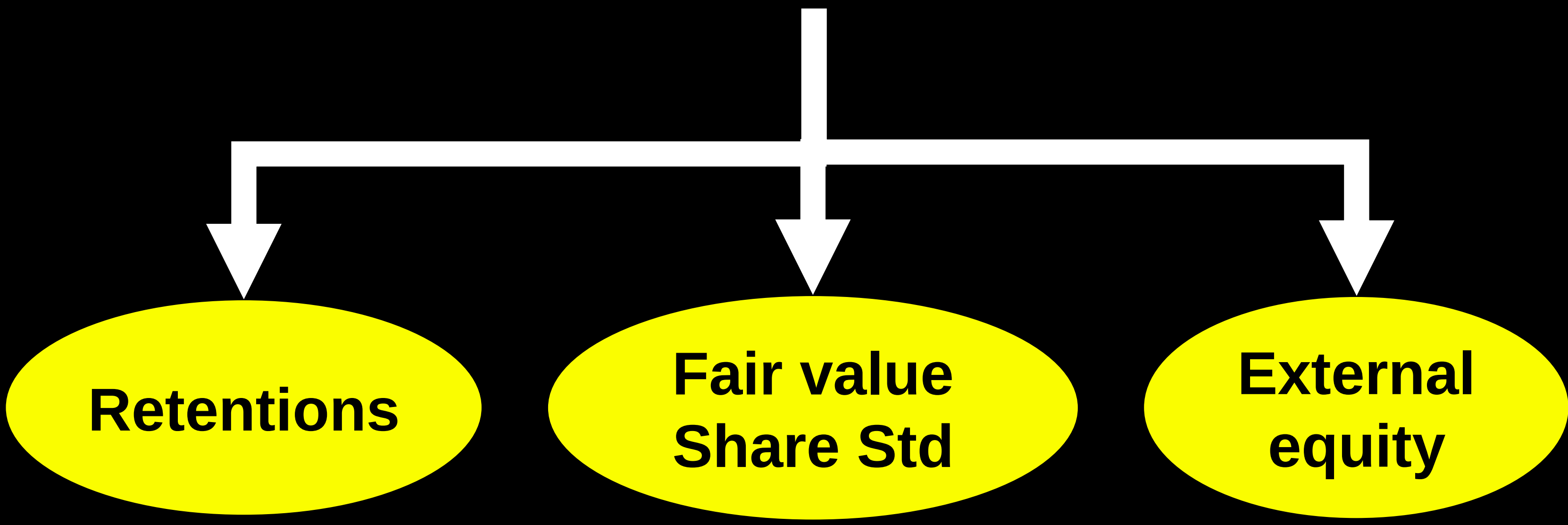
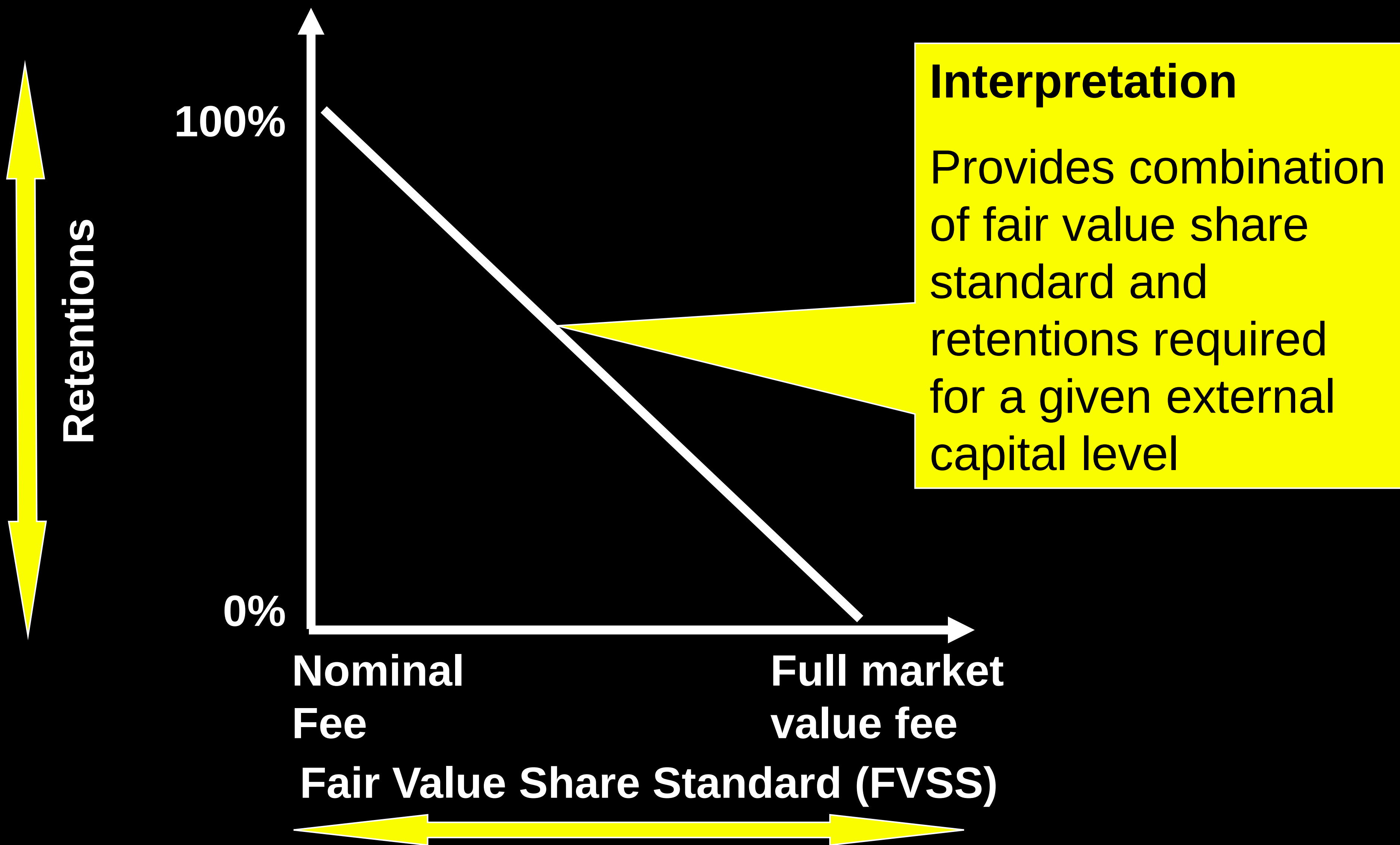
FINANCIAL CAPACITY

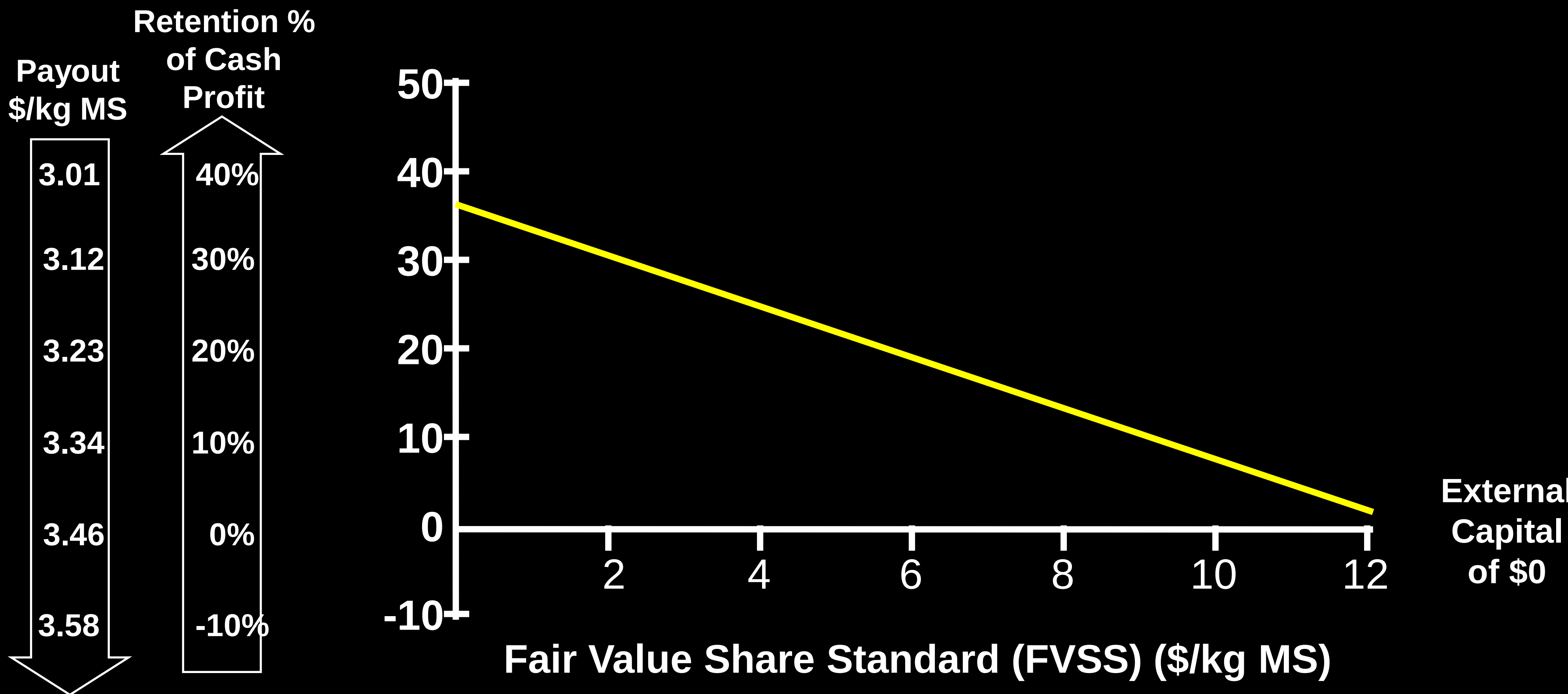
	$NZ billions
Total Capital required	12
Less Debt capacity	8
Additional capital required	4



RETENTIONS VS FAIR VALUE SHARE STANDARD (FVSS)



AVERAGE RETENTION / PAYOUT VS AVERAGE FVSS: BASE CASE



QUESTION

Do we need to structure parts of the business to provide for external equity?

ANSWER

We should structure the downstream parts of the business to provide the option of external equity in the future, including

- **Consumer**
- **Ingredients slivers**

CAPITAL / OWNERSHIP QUESTIONS

External / Internal equity	• Do we need to structure parts of the business to provide for external equity?	Yes
Corporate vs co-operative	• Should the Industry maintain a co-operative ownership structure for all parts of the business?	
Ownership Linked/ Delinked to Supply	• Should returns from downstream investments be delinked from supply?	
Differentiated/ Uniform Payout	• Should the Industry have the ability to differentiate payout?	

CORPORATE VS CO-OPERATIVE

UPSTREAM

- Milk processing
- Merchant
- Trading
- Ingredients

- No transparent transfer prices
- Supplier control required

Co-operative structure to protect/serve farmer interests

DOWNSTREAM

- Consumer
- Ingredient slivers

- Transparent transfer prices
- Supplier control not required

Corporate structure to drive performance

QUESTION

Should the Industry maintain a co-operative ownership structure for all of the business?

ANSWER

Co-operative structure required for

- **Manufacturing**
- **Merchanting**
- **Trading**
- **Ingredients**

Corporate structure desired for

- **Consumer**
- **Ingredients slivers**

CAPITAL / OWNERSHIP QUESTIONS

External / Internal equity	• **Do we need to structure parts of the business to provide for external equity?**	**Yes**
Corporate vs co-operative	• **Should the Industry maintain a co-operative ownership structure for all parts of the business?**	**No**
Ownership Linked/ Delinked to Supply	• **Should returns from downstream investments be delinked from supply?**	
Differentiated/ Uniform Payout	• **Should the Industry have the ability to differentiate payout?**	

LINKED VS DELINKED

Required

- Avoid dilution of suppliers wealth from increased milk supply
- Send correct economic signal for new milk

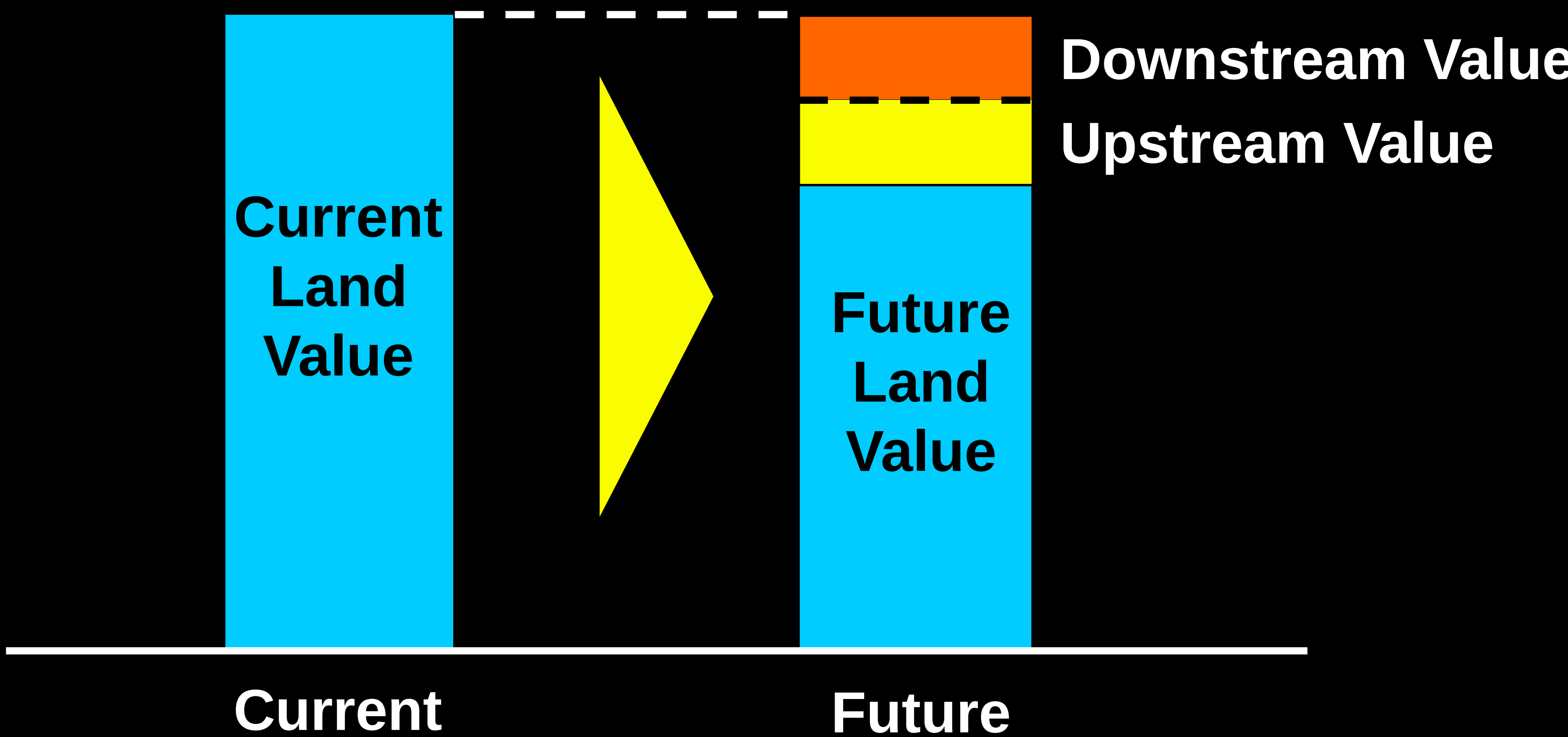
Rationale

- Avoid uneconomic production
- Total returns (both on and off-farm) remain unchanged or increase

Issue

- Debt carrying capacity is an issue to be addressed

IMPACT ON FARM ASSETS



QUESTION

Should returns from downstream investments be delinked from supply?

ANSWER

Returns from downstream investments should be linked to ownership and not supply to ensure correct economic signals are sent to suppliers

CAPITAL / OWNERSHIP QUESTIONS

External / Internal equity	• Do we need to structure parts of the business to provide for external equity?	Yes
Corporate vs co-operative	• Should the Industry maintain a co-operative ownership structure for all parts of the business?	No
Ownership Linked/ Delinked to Supply	• Should returns from downstream investments be delinked from supply?	Yes
Differentiated/ Uniform Payout	• Should the Industry have the ability to differentiate payout?	

DIFFERENTIATED VS UNIFORM PAYOUT

Problem

- A new entrant could cherry pick opportunities and pay more than a commodity milk price

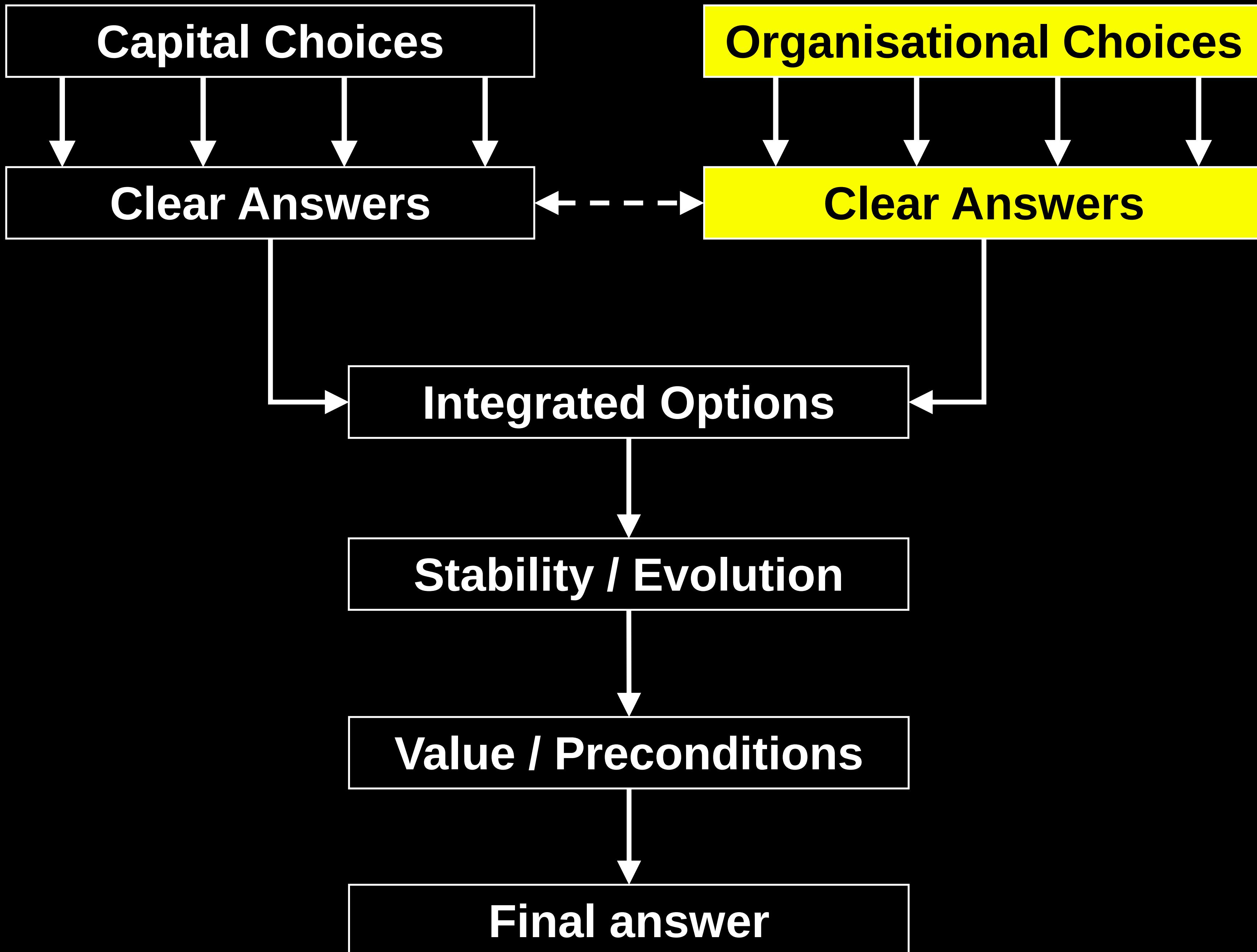
Required

- CMP and cost structures must reflect true economics of milk
- National farmgate milk price but - constitutional changes possible

CAPITAL / OWNERSHIP QUESTIONS

External / Internal equity	• **Do we need to structure parts of the business to provide for external equity?**	**Yes**
Corporate vs co-operative	• **Should the Industry maintain a co-operative ownership structure for all parts of the business?**	**No**
Ownership Linked/ Delinked to Supply	• **Should returns from downstream investments be delinked from supply?**	**Yes**
Differentiated/ Uniform Payout	• **Should the Industry have the ability to differentiate payout?**	**Current No***

*** Constitutional change required**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ORGANISATION QUESTIONS

Marketer

- **Will fully competing marketers destroy value?**
- **Will specialised marketers be superior to a single marketer?**

Manufacturer

- **Should we have single or multiple manufacturers?**

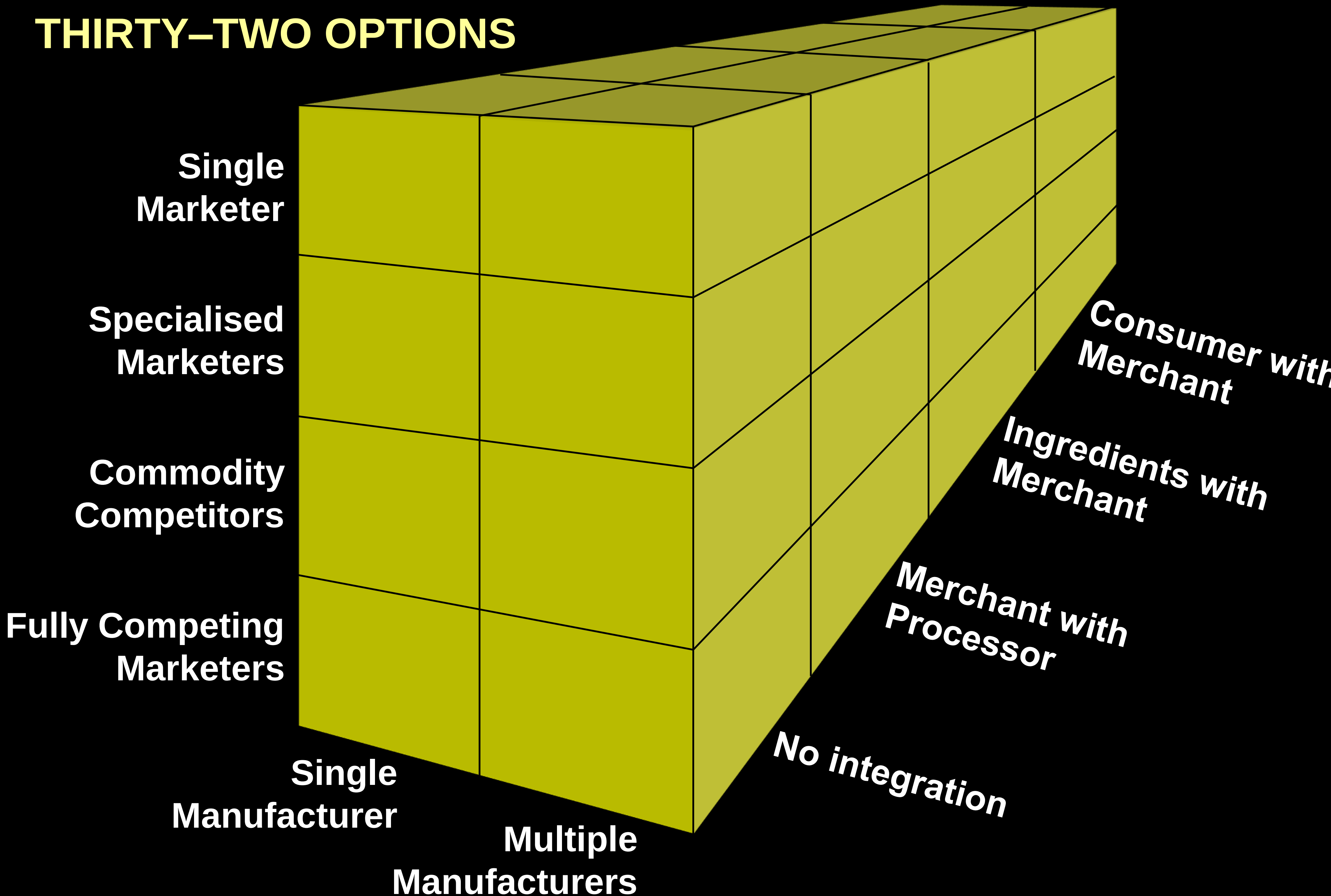
Vertical/ Horizontal

- **Should we integrate merchanting and processing?**
- **Should we integrate ingredients and merchanting?**
- **Should we integrate consumer and merchanting?**

Atomised/ Centralised

- **How can we organise to drive performance?**

THIRTY–TWO OPTIONS



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Atomised/ Centralised

- How can we organise to drive performance?

QUESTION: SHOULD WE HAVE SINGLE OR COMPETING MARKETERS?

Fully Competing marketers	Commodity competitors	Specialised marketers	Single marketer
Competition in all segments of the market	• Specialised marketers – Consumer – Ingredients • Competition in commodities via trader	Specialised marketers – Consumer – Ingredients	One marketer

CRITERIA FOR EVALUATING THE OPTIONS

Ability to realise strategy

Impact of marketplace competition

Impact of scale

Impact of performance transparency

QUESTION

Will fully competing marketers destroy value?

FINDING

- **Fully competing marketers have reduced scale, reduced ability to achieve strategy and will compete away premiums**
- **Benefits of competition insufficient to offset this value loss**

ANSWER

Yes - fully competing marketers will destroy value

QUESTION

Will specialised marketers be superior to a single marketer?

FINDING

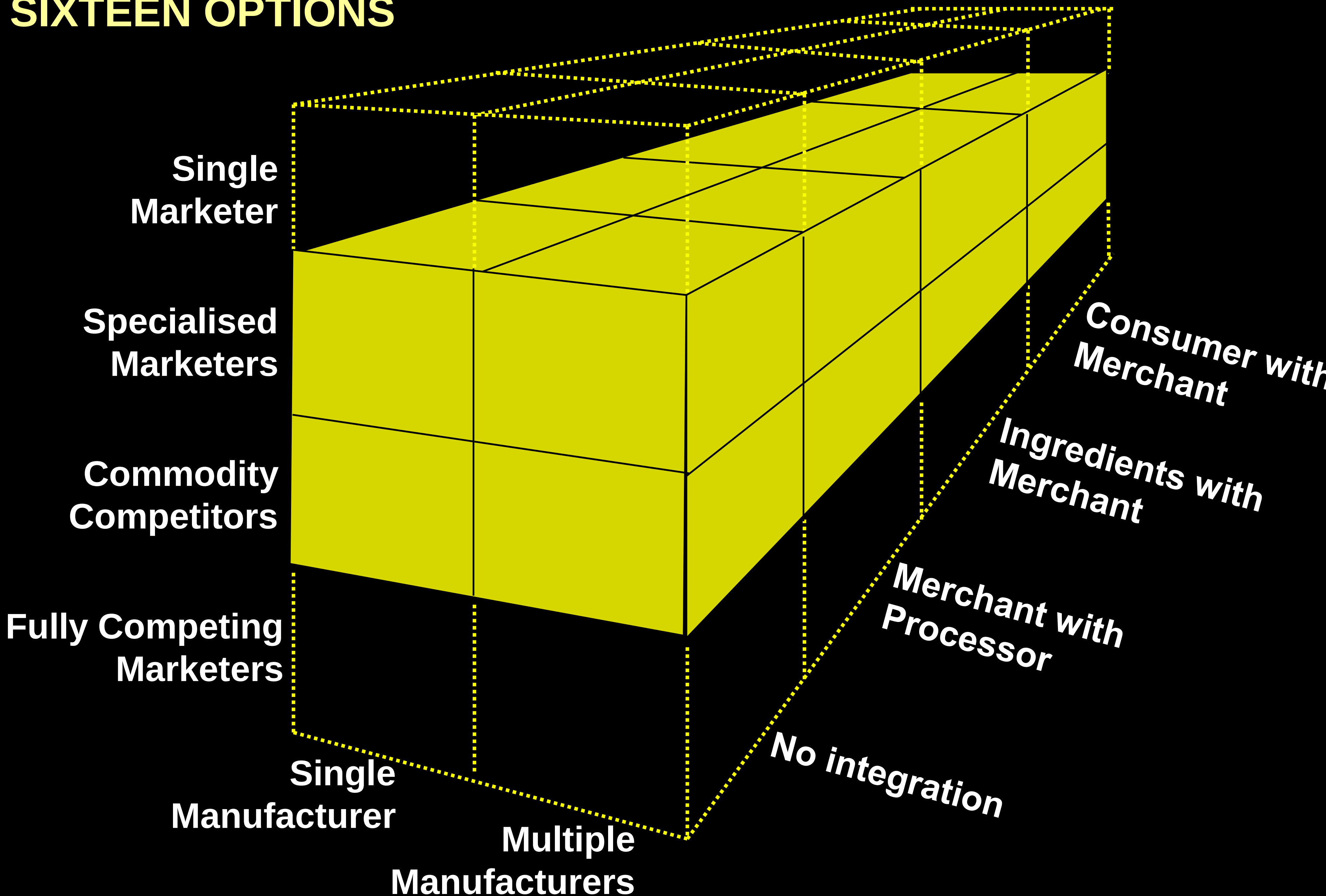
- **Consumer must be structured separately to allow for the introduction of external equity in the future**
- **The positive impact of commodity competition will largely offset scale and premium losses**

ANSWER

A single marketer is not feasible given consumer needs

Specialised marketers are feasible, either
- **Ingredients and consumer**
- **Ingredients and consumer, commodity competition**

SIXTEEN OPTIONS



ORGANISATION QUESTIONS

Marketer

- **Will fully competing marketers destroy value?** **Yes**
- **Will specialised marketers be superior to a single marketer?** **Yes**

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ECONOMIES OF SCALE BENEFITS: MANUFACTURING
$ millions annual savings

	One Company	Two large companies
Total synergies	50 - 80	35 - 55

Difference between one and two large manufacturers is $15-25 million pa

QUESTION

Should we have single or multiple manufacturers?

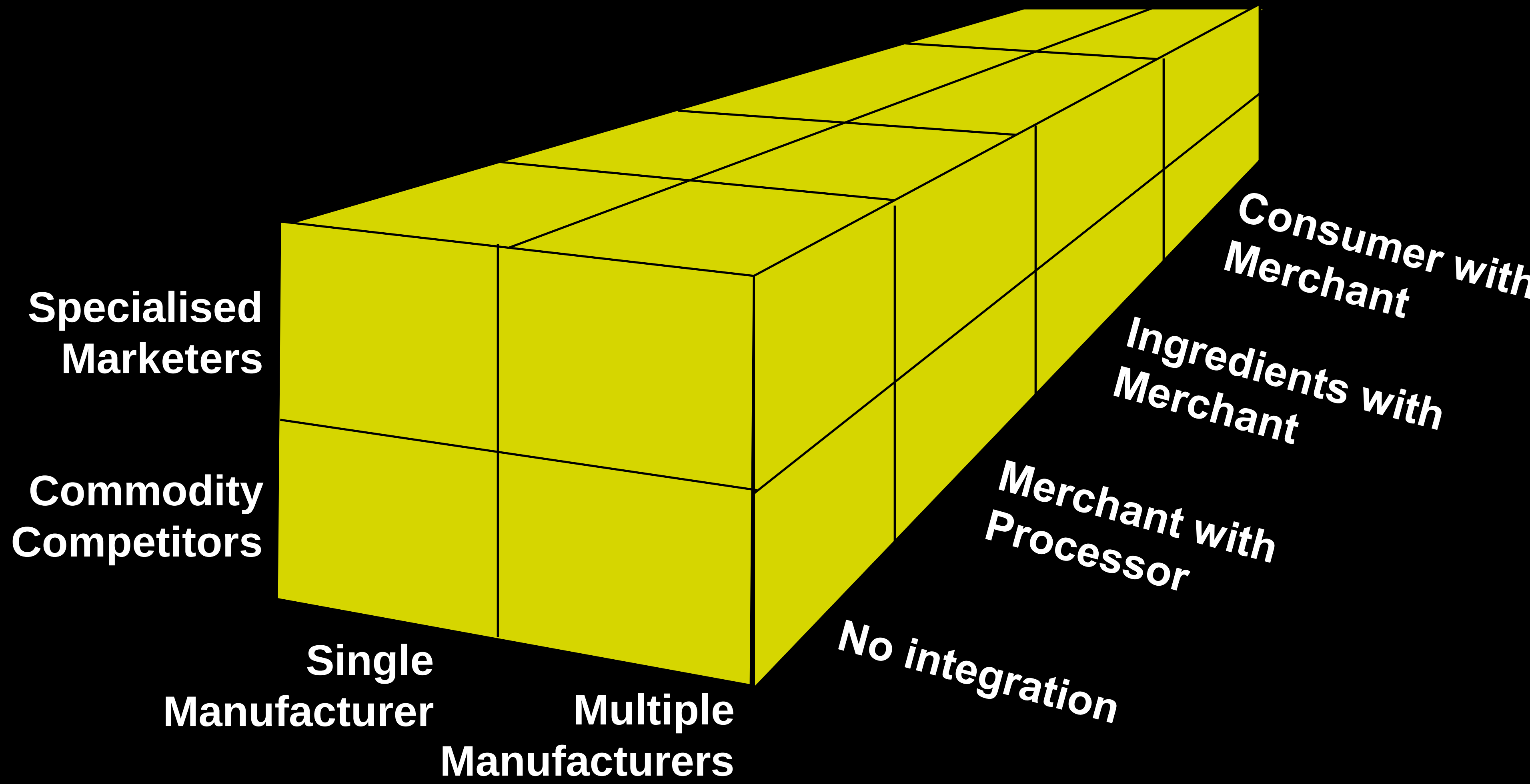
FINDING

Performance losses of 0.5% could offset synergy gains

ANSWER

Not defining

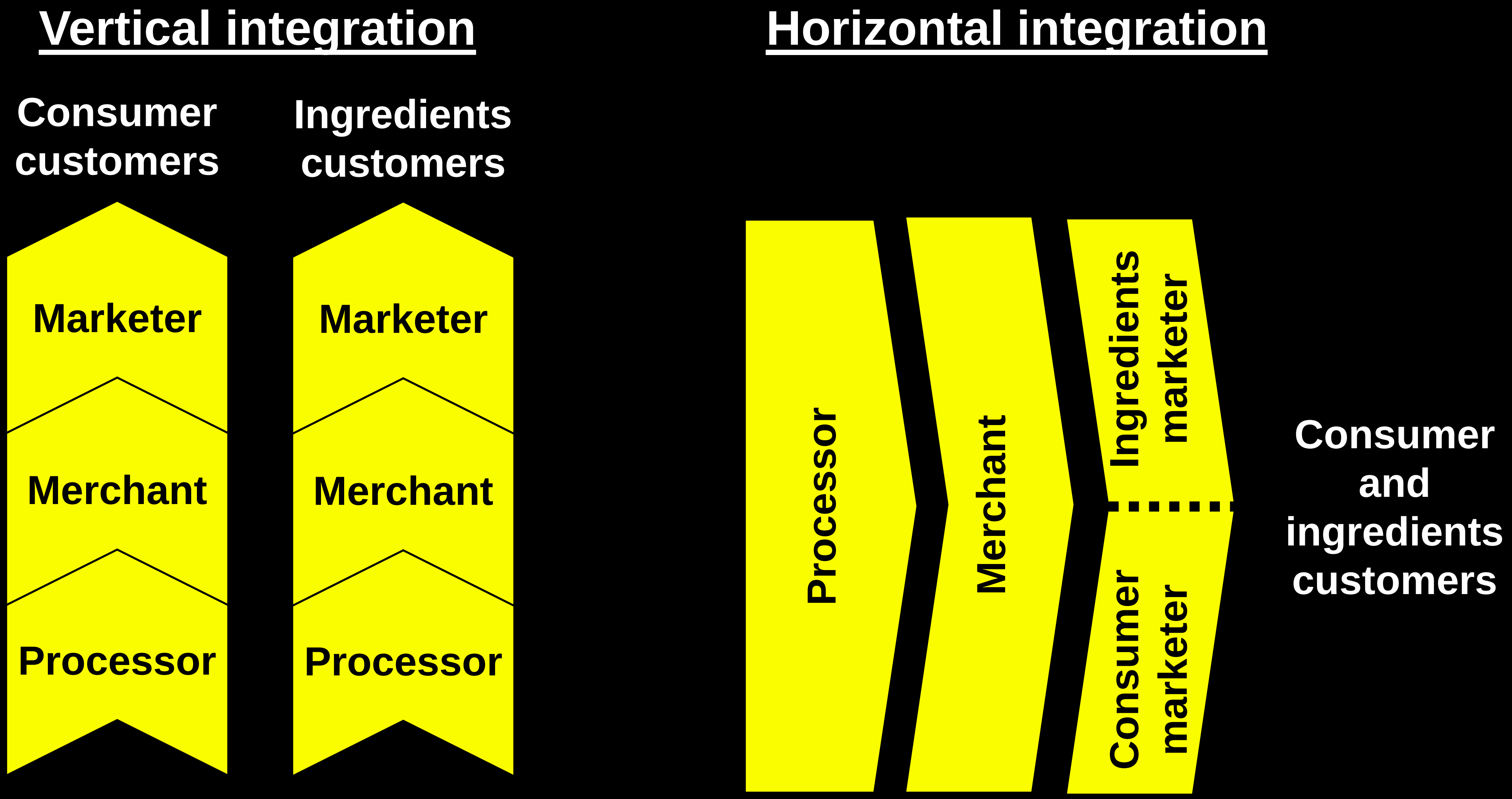
SIXTEEN OPTIONS



ORGANISATION QUESTIONS

Marketer	• Will fully competing marketers destroy value? • Will specialised marketers be superior to a single marketer?	Yes Yes
Manufacturer	• Should we have single or multiple manufacturers?	Not defining
Vertical/ Horizontal	• Should we integrate merchanting and processing? • Should we integrate ingredients and merchanting? • Should we integrate consumer and merchanting?	
Atomised/ Centralised	• How can we organise to drive performance?	

HOW DO WE INTEGRATE THE DIFFERENT PARTS OF THE BUSINESS



QUESTION

Should we integrate merchanting and processing?

FINDINGS

- **No intermediate transfer price**
- **Closely linked business systems**

ANSWER

Yes - we should integrate merchanting and processing

QUESTION

- Should we integrate ingredients and merchanting?

FINDINGS

- Risk of destructive competition
- Revisit as market evolves

ANSWER

Yes - we should integrate ingredients and merchanting

QUESTION

Should we integrate consumer and merchanting?

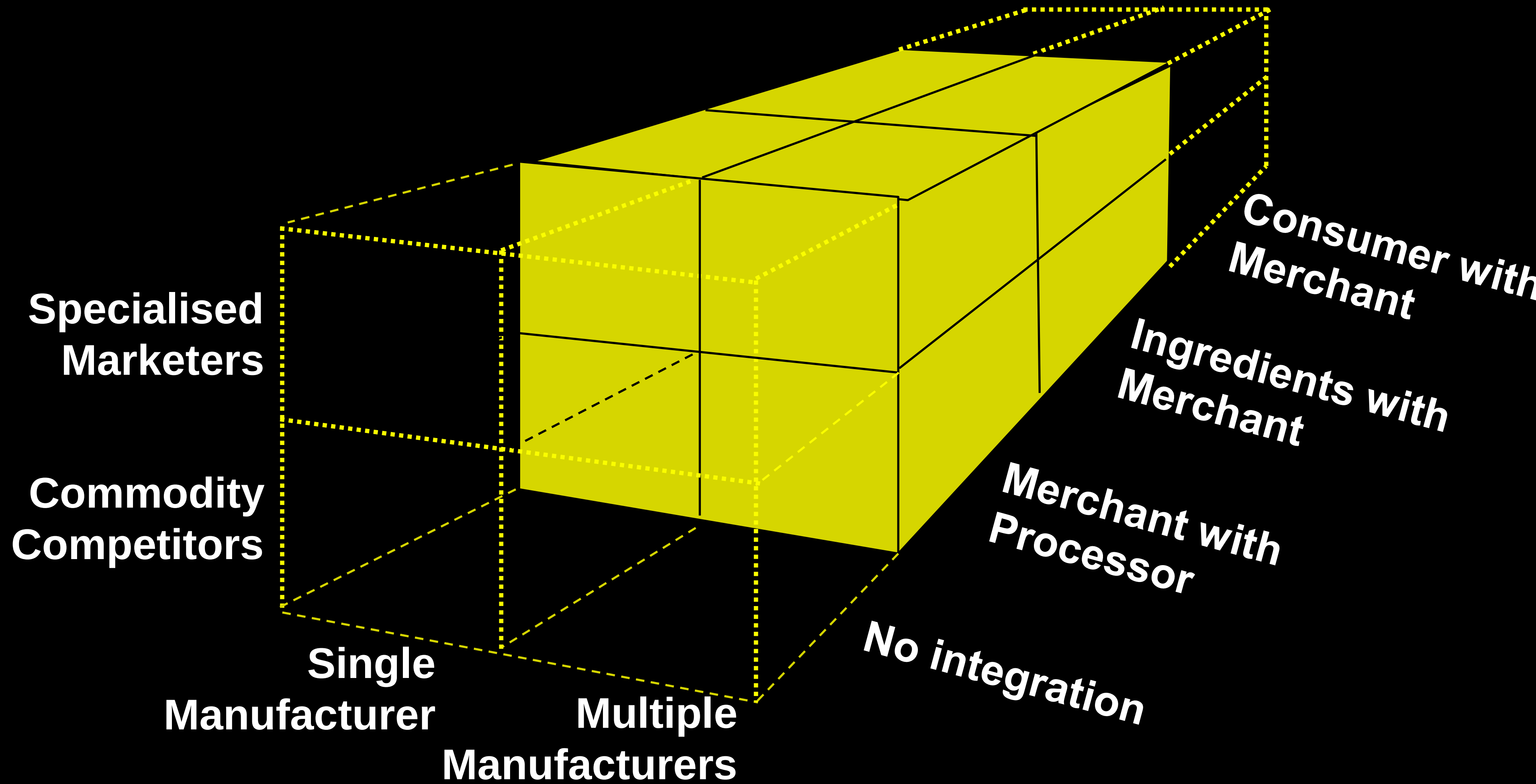
FINDINGS

- **Manage complexity/diversity**
- **Prepare for external equity**

ANSWER

No - we should structure consumer so it can be separated from merchanting

FOUR REMAINING OPTIONS



ORGANISATION QUESTIONS

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	• Will specialised marketers be superior to a single marketer?	Yes
Manufacturer	• Should we have single or multiple manufacturers?	Not defining
Vertical/ Horizontal	• Should we integrate merchanting and processing?	Yes
	• Should we integrate ingredients and merchanting?	Yes
	• Should we integrate consumer and merchanting?	No
Atomised/ Centralised	• How can we organise to drive performance?	

QUESTION

How can we organise to drive performance?

ANSWER

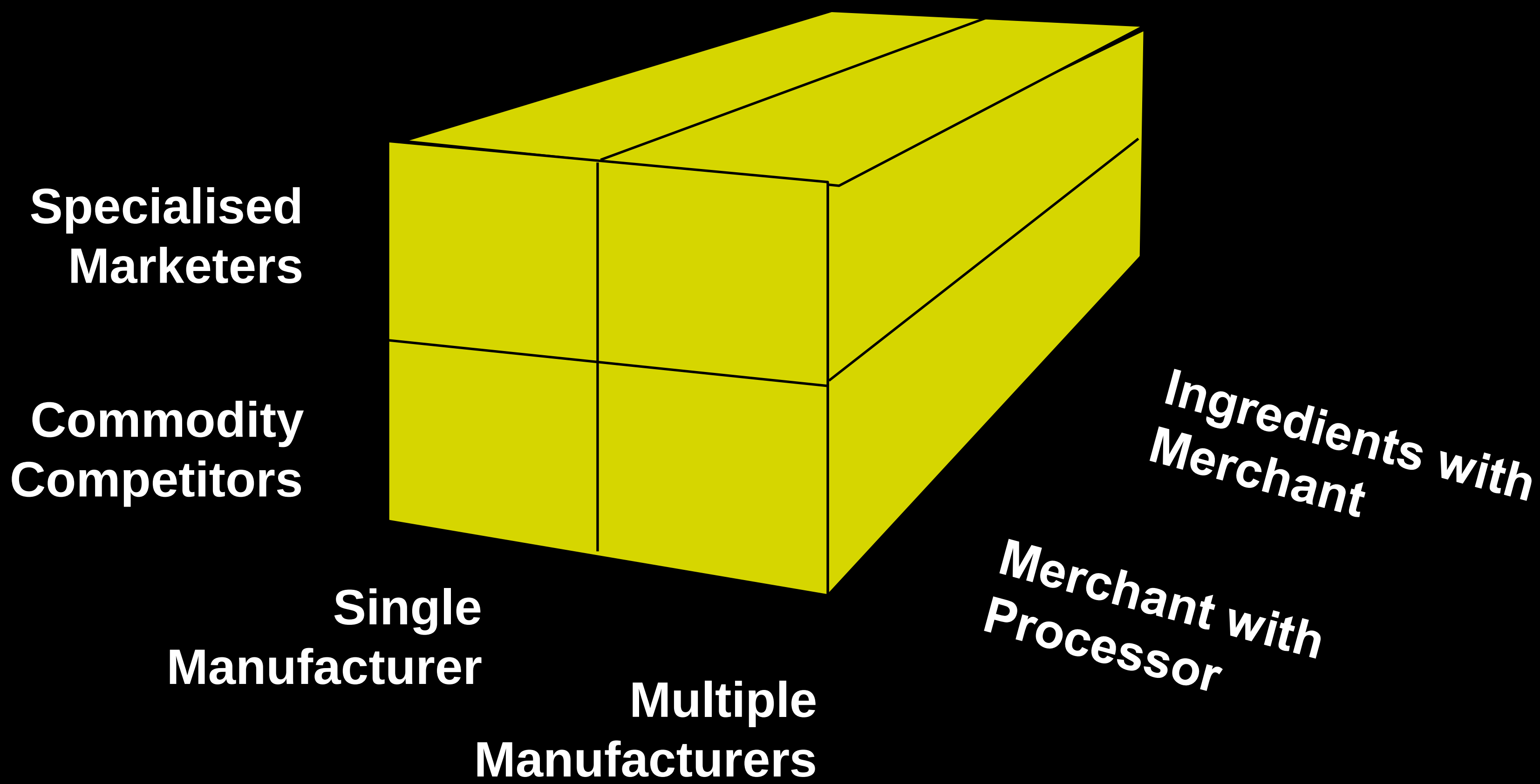
Performance management within specialised marketers or a single milk processor will require:

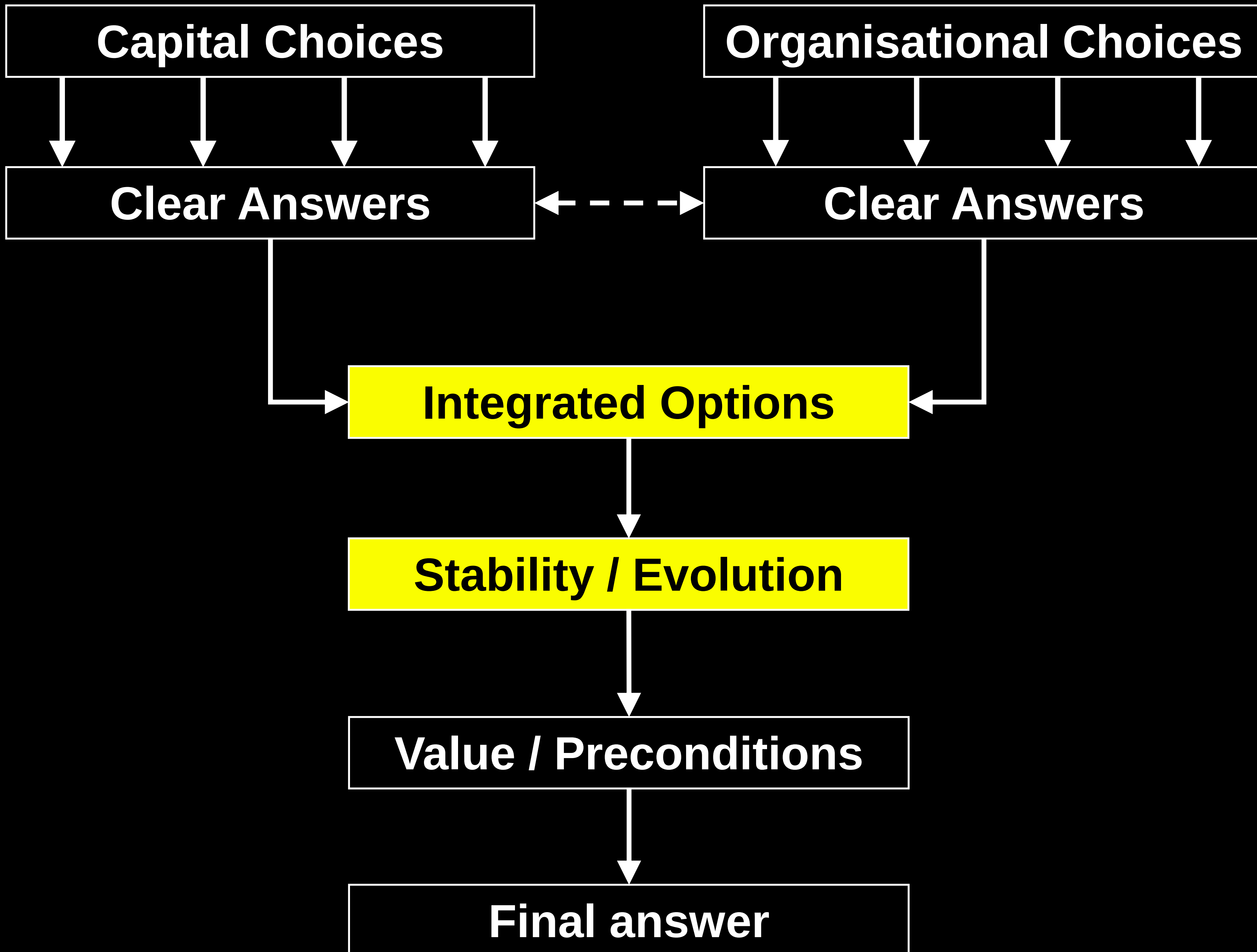
- **replication of external markets within the organisation**
- **breaking the organisation into a large number of transparent (but connected) performance units**

ORGANISATION QUESTIONS

Marketer	• Will fully competing marketers destroy value?	Yes
	• Will specialised marketers be superior to a single marketer?	Yes
Manufacturer	• Should we have single or multiple manufacturers?	Not defining
Vertical/ Horizontal	• Should we integrate merchanting and processing?	Yes
	• Should we integrate ingredients and merchanting?	Yes
	• Should we integrate consumer and merchanting?	No
Atomised/ Centralised	• How can we organise to drive performance?	Atomised

FOUR REMAINING OPTIONS

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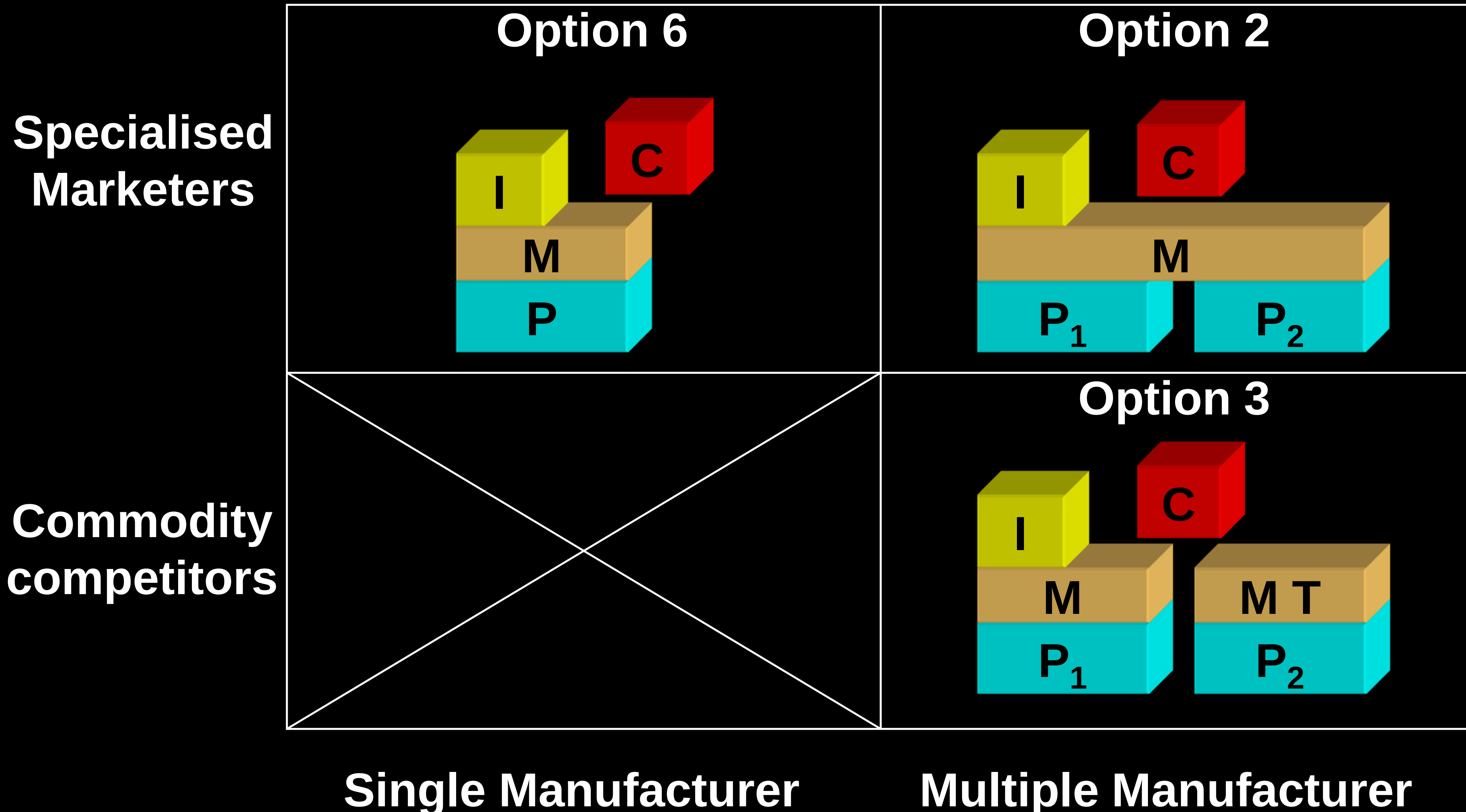
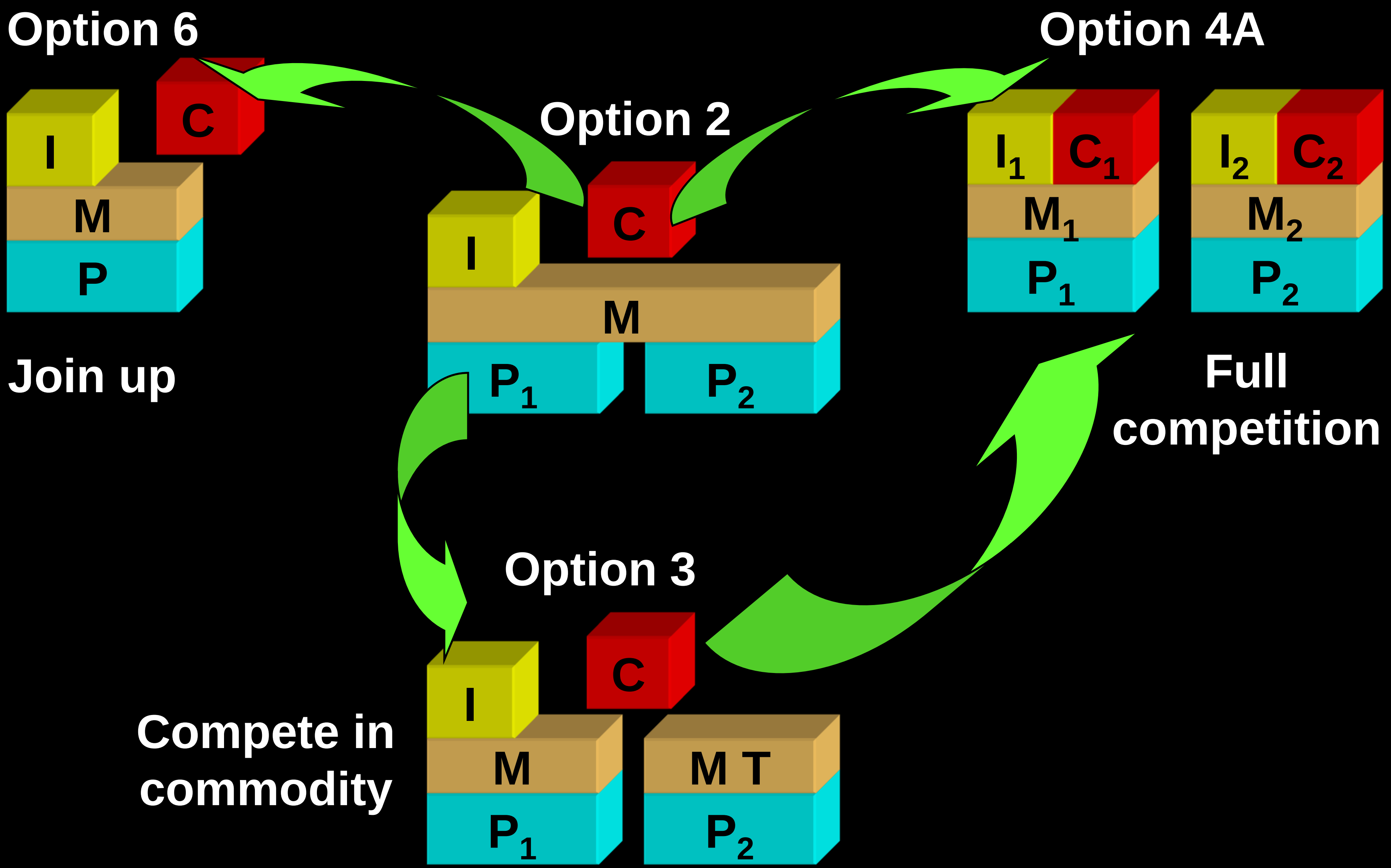
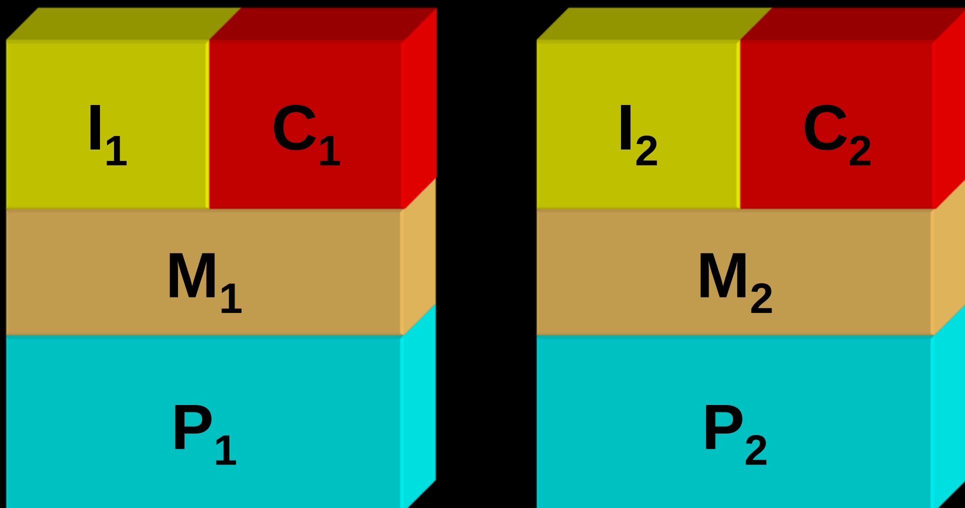
ORGANISATIONAL OPTIONS



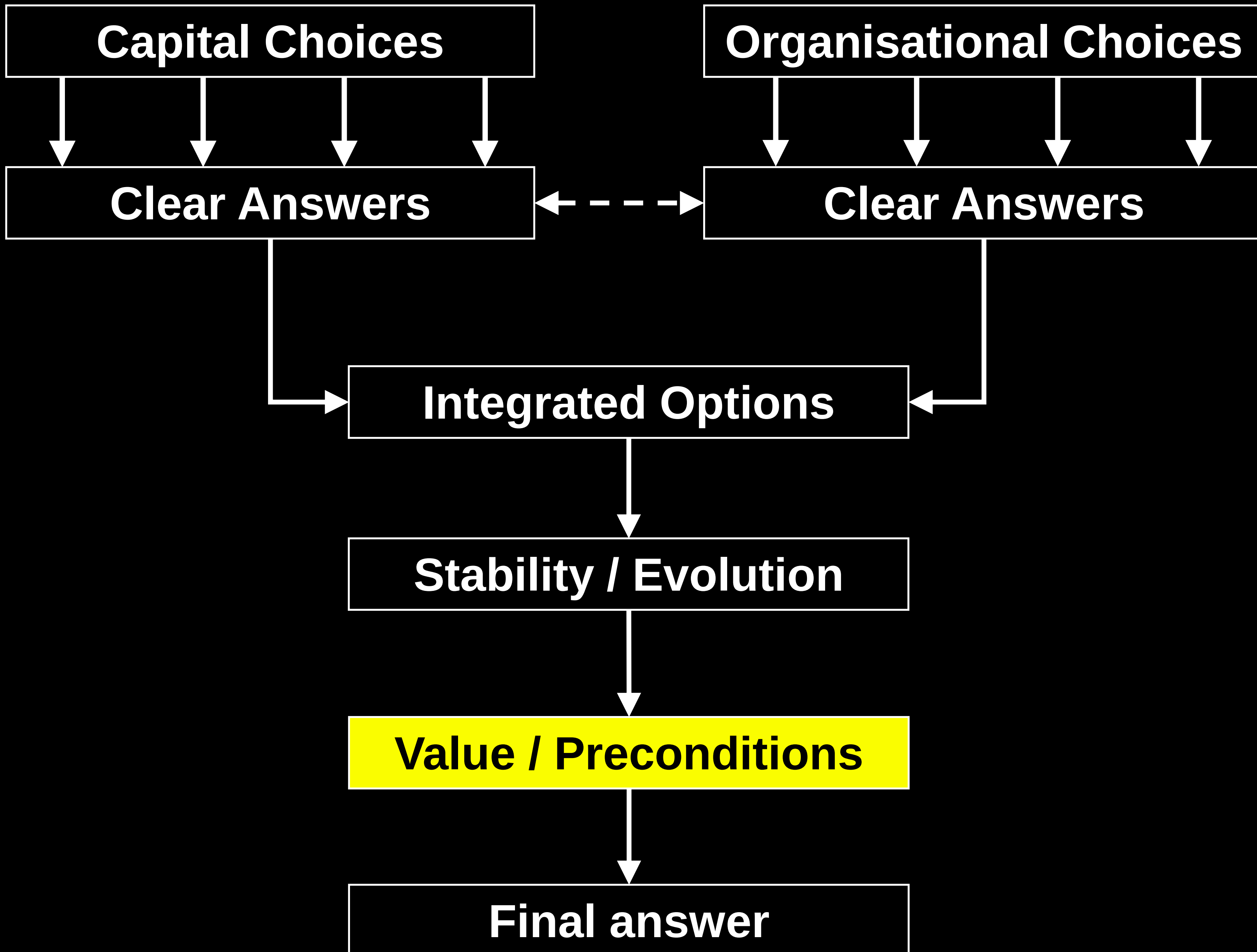
OPTION 2 IS CONSIDERED UNSTABLE



REMAINING OPTIONS: OPTION 4A



Fully integrated competing companies - competition in both consumer and ingredients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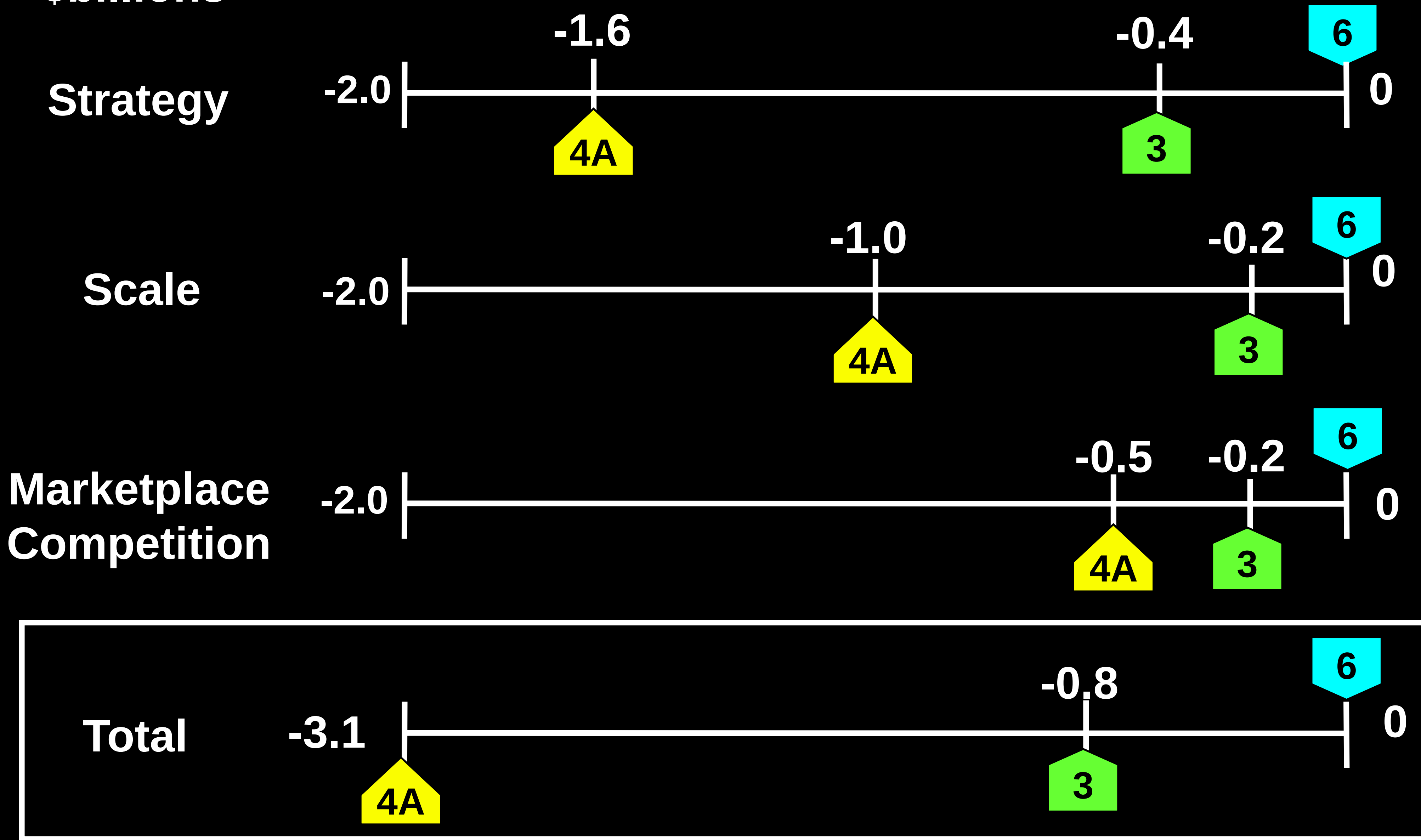
CRITERIA FOR EVALUATING THE OPTIONS

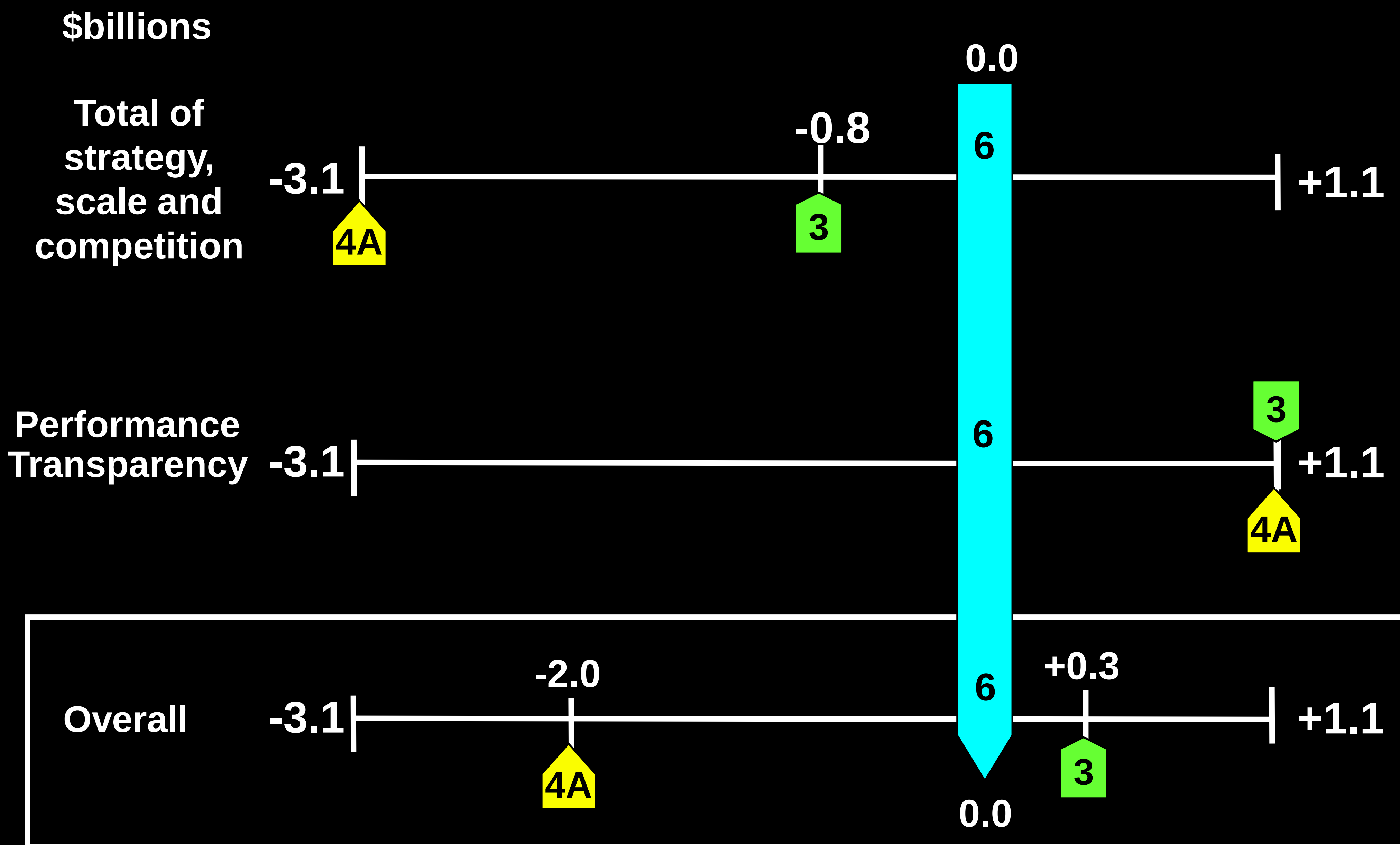
Ability To Realise Strategy	Impact Of Scale	Impact Of Marketplace Competition	Impact Of Performance Transparency
Fragmentation Competition	Manufacturing Marketing	Premium above commodity New Zealand umbrella brand Destructive competition	External performance pressure Impact on x-inefficiency

COMPARISON VS OPTION 6

$billions

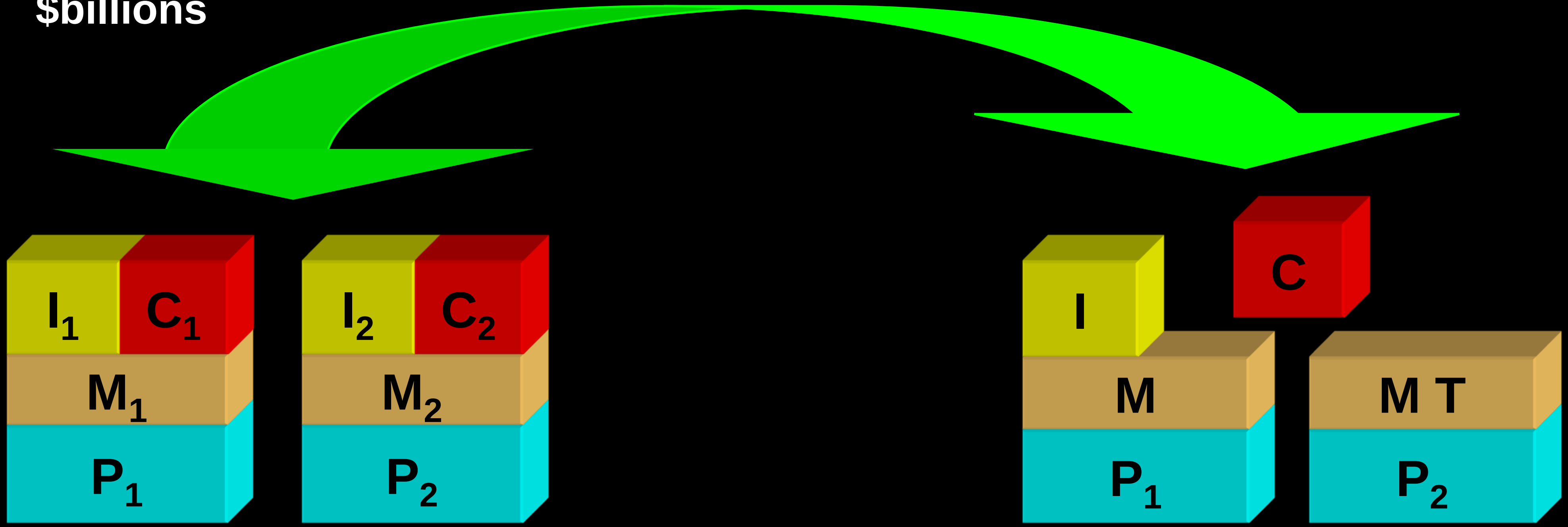


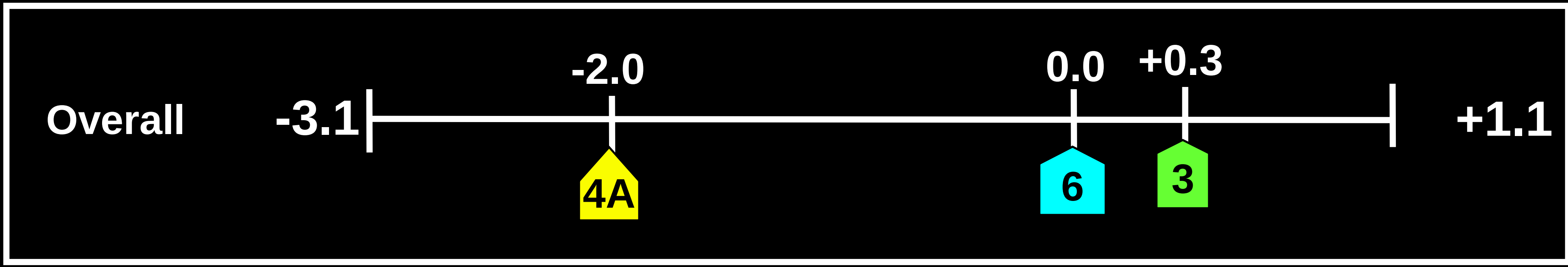
OVERALL COMPARISON VS OPTION 6



DOWNSIDE OF OPTION 3 IS HUGE

$billions





SUMMARY

Option 6 is preferable to a pure Option 3 by $800 million if x-inefficiency can be eliminated

Otherwise a pure Option 3 is preferable to Option 6 by $300 million if breakdown of Option 3 can be prevented

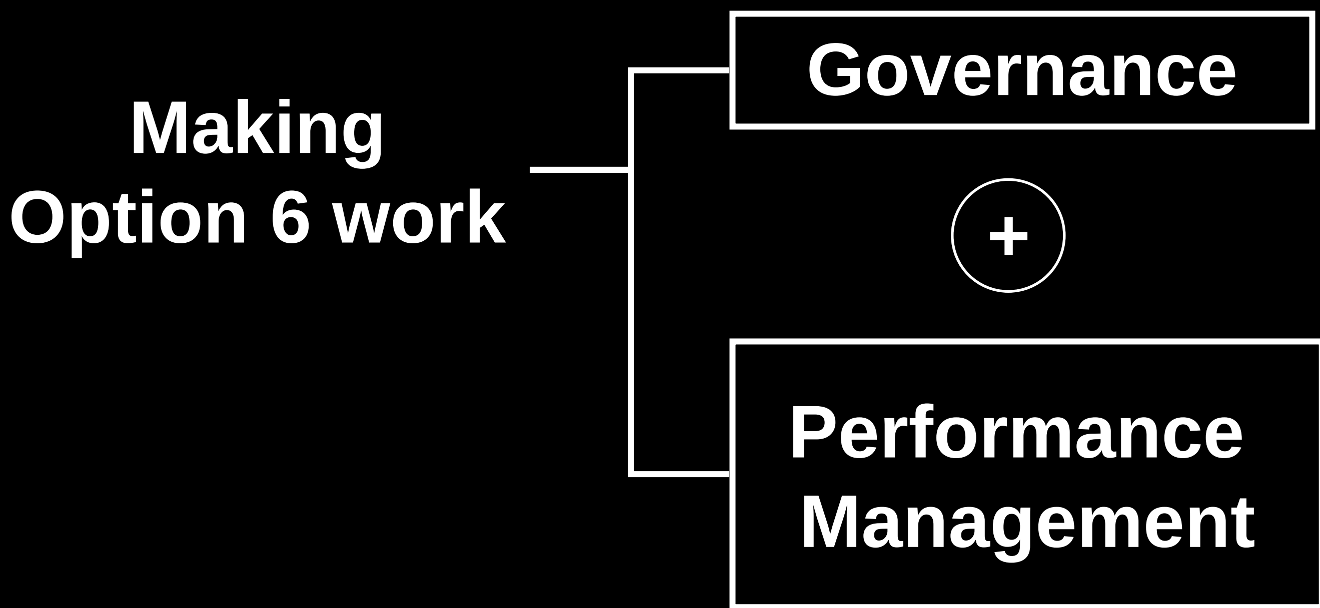
We believe that the x-inefficiency can be managed under Option 6

THE VALUE OF THE STRATEGY IS DRIVING THE STRUCTURE

$millions pa

	Status Quo	Option 6	Option 3	Option 4A
Equivalent annual NPV of total strategy, scale and competition	**0 ?**	**350**	**270**	**40**

MAKING OPTION 6 WORK



GOVERNANCE MEASURES TO DELIVER ON OPTION 6

Governance Measures		Rationale
Clearly defined strategy	→	Enable farmers to judge performance
Targets aligned to strategy	→	Hardwire in strategic goals
Measures aligned to value creation	→	Tangible wealth creation
Independent Directors	→	Improved Board performance
Active farmer reviews	→	Farmers custodians of performance
Consequences for non-performance	→	Critical to any performance system

EFFECTIVE PERFORMANCE MANAGEMENT

Challenges	Principles	Solution
• No transparent milk price • Administered product prices	• Replicate the market	• Single independently administered NZ milk price • Arms length based transfer prices
• “Big company” • Diverse and complex	• Provide farmer choice • Organise around small performance cells	• Separate off areas of business specalisation • Accountable, autonomous performance cells • Aggressive targets

EFFECTIVE ORGANISATIONAL DESIGN

Key Features

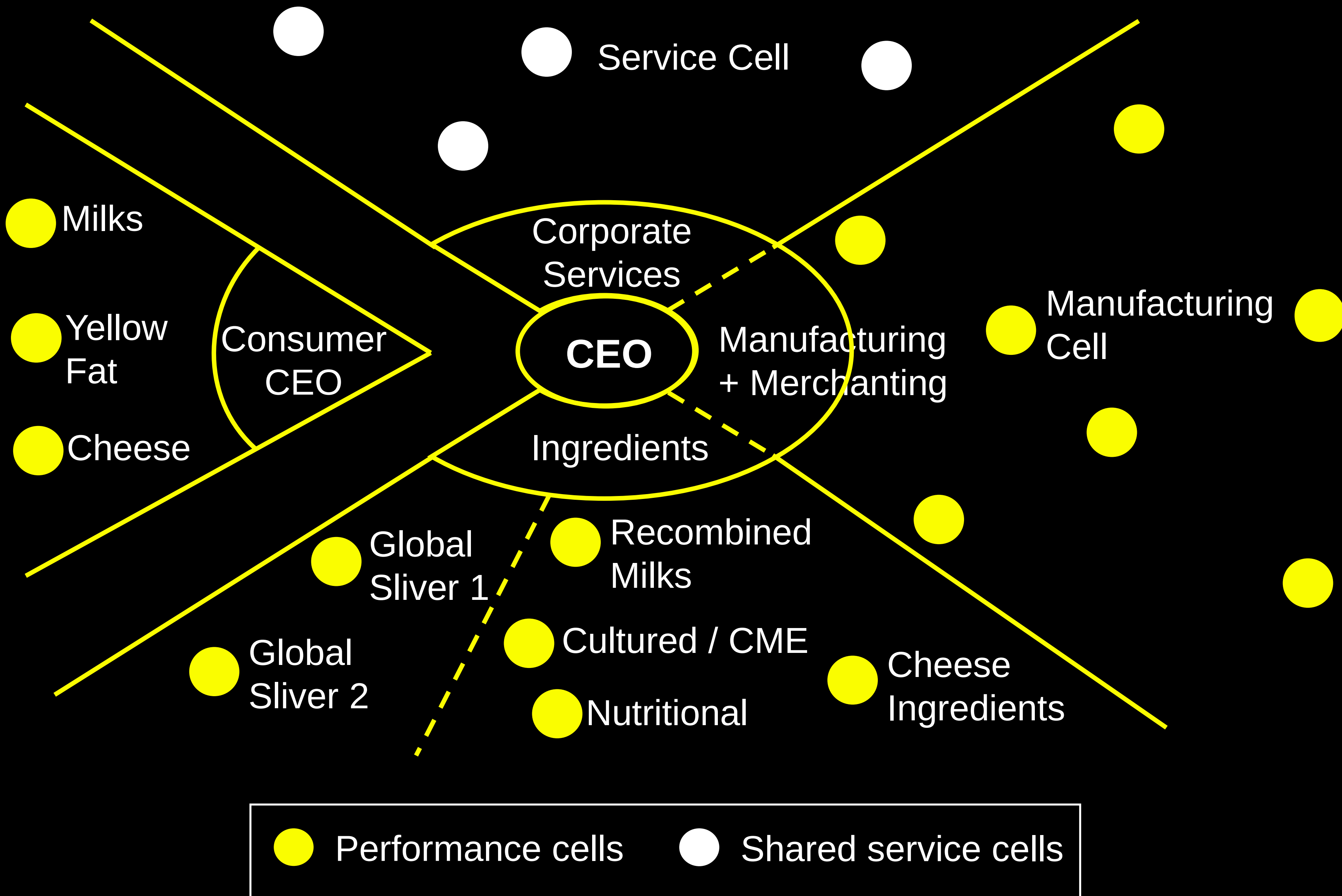
- Flat
- Lean
- Autonomous
- Accountable
- Co-ordinated

How is it different?

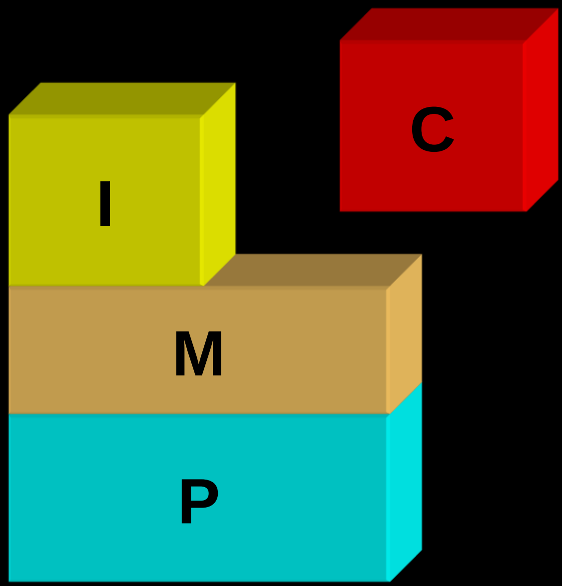
- More transparency
- More accountability
- More autonomy

ILLUSTRATIVE BUSINESS/OPERATIONS STRUCTURE

ILLUSTRATIVE



OPTION 6



Consumer separate subsidiary.

Single company for processing, merchanting and ingredients