

# Fonterra sees world as land of milk and money

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Prices for milk and skim milk powder are as high as they've ever been, but the changing face of the world dairy industry means Fonterra is increasingly looking overseas for new supply. Andrew Janes reports.

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IT IS a far cry from the early 1990s when the New Zealand dairy industry's main concern was where it was going to sell its so-called white wall of milk.

Back then the conversation was about whether New Zealand would be better off producing less milk, says Fonterra head of strategy Graham Stuart. "We even looked at disposing of butterfat by burying it or burning it in boilers. In the end we sold it to Russia, though we didn't get much money for it."

Times have certainly changed. Today international prices for whole milk and skim milk powder are the highest they have ever been. Demand is predicted to stay strong.

Fonterra's latest forecast shows global demand for dairy products growing at 2.7 per cent a year to 2014, outpacing supply growth of 2 per cent a year.

"It's the most optimistic demand forecast we've ever put together," he says.

Paralleling the rising demand is a change in the nature of the international industry. Instead of established dairy industries in Europe, North America, Australia and New Zealand lifting their exports, much of the new output will come from emerging dairy industries in China, South America and Eastern Europe supplying their own growing markets.

Though Fonterra has always looked overseas for export markets, the dairy cooperative is now looking overseas for new supply as well, trying to replicate its cow-to-consumer supply chain in new markets.

"We see some of these new trends and ask ourselves and our farmers, Do we want to sit on the sidelines?" says chief executive Andrew Ferrier. "The message we give to our farmers is that Fonterra can't sit still."

Dairy's rosy outlook is underpinned by factors as diverse as rising oil prices and Australia's drought. When Fonterra was set up in 2001, the European Union was the

international market's major dairy supplier. "But as the EU's budget woes have bitten we've seen export subsidies come off," Mr Ferrier says.

Fonterra now expects the EU's contribution to world dairy supply not to grow at all in the next 10 years.

In North America, biofuels' growing popularity is lifting the cost of dairy production and constraining new supply. Most US dairy cows are fed with corn, but its price has shot up recently because it is a feedstock for bio-ethanol. US supply will probably meet rising demand, but Mr Stuart says not much will be left for export.

That leaves just Australia and New Zealand. But given the debilitating drought across the Tasman, Fonterra says New Zealand is the only established dairy industry with the potential to significantly increase its supply.

Dairy demand is also being driven by a growing consumer preference for healthy food.

"Consumers around the world are increasingly recognising that their diet is a significant contributor to their long-term health and that plays into the sweet spot around dairy," Mr Ferrier says.

High oil prices are inflating the per capita gross domestic product of oil-producing countries, creating pre-conditions for higher dairy consumption.

"As much as we might complain about high oil prices on the cost side of the business, they are having a very positive impact on the revenue side," Mr Stuart says.

Crucially for Fonterra, the pattern of increasing dairy consumption is also changing. "Traditionally we've seen markets go from sweetened condensed milk into basic forms of skim milk powder up into functional powders and ultimately, when gdp per capita hits upwards of US\$5500 to US\$6000, they move up into UHT milks, pasteurised milk and yoghurts," Mr Stuart says.

"But what we are seeing now is this whole development chain, particularly in China, being truncated with consumers jumping straight into liquid milks."

China should account for a third of international demand growth in the next decade but Fonterra admits to being somewhat confounded by the Chinese dairy sector's growth.

"Five years ago we saw strong growth in demand in China but we couldn't see supply keeping up with that," Mr Stuart says.

"We had a bullish outlook about how much milk powder we would be exporting to China. But China has not only achieved its demand forecast but they've also backed it up with supply.

"We've now recalibrated our forecasts and we're projecting really strong growth in dairy demand in China but it's going to be met largely in the next decade with increased Chinese supply."

Growing preference for liquid milk means this may be repeated in other emerging dairy markets.

Though demand is forecast to grow at 2.7 per cent a year till 2014, cross-border trade will account for less than half of that at 1.2 per cent a year.

"But that's not something to beat ourselves up about," Mr Stuart says. "That's more than enough demand to meet our expectations of production growth in New Zealand. We aren't going to run out of markets for New Zealand products."

IT IS overseas where Fonterra sees the real action. In the ingredients side of the business about a quarter of its sales now come from non-New Zealand supply, which is fed into Fonterra's global supply chain.

"That's grown from damn near zero when Fonterra was formed in 2001," says Fonterra chairman Henry van der Heyden.

Becoming a multiple-origin ingredients supplier enables Fonterra to make itself increasingly indispensable to its major international customers, Mr Ferrier says. "If you go back three or four years ago when we were primarily a New Zealand-centric supplier we might have been supplying 30 per cent of a large international customer's requirements. They didn't want to go above that because they saw buying from one country as a risk.

"But the ability to have multi-origin product offerings changes that risk profile quite dramatically. In some of the larger global dairy customers around the world we are now supplying 60 or 70 per cent of their global supply."

By increasing in importance as a supplier Fonterra can move up the supply chain, he says. "Where they might have bought whole milk powder in the past, now they buy a finished product such as infant formula, packaged in New Zealand, or possibly somewhere in Asia, and delivered to them."

Fonterra sees a big opportunity for growth in the next decade by replicating its business model in emerging domestic dairy industries. China, where it has a joint venture with dairy company Sanlu, is an example of that, Mr Ferrier says.

"In China you see our investments moving right through the supply chain, literally from farming right up to consumer products. The same thing goes in South America in our joint venture with Nestle."

Fonterra's next region in line for investment could be former Soviet countries Ukraine and Belarus.

"The real action is happening behind borders and the real action is happening in liquid and chilled products and the real action that interests us most is in building new dairy industries that haven't existed before."