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Fonterra goes cool on another milk run

Australian dairy industry experts say Fonterra has one chance if it wants to grab a bigger chunk of the $4 billion market across the Tasman - that is to swoop on Dairy Farmers when it lists next year.

But Fonterra's failure to take over market leader National Foods in 2005 seems to have left the dairy giant gun-shy about the A$1.3 billion co-operative.

"I won't chase businesses at any cost," Fonterra chief executive Andrew Ferrier said this week from Australia, where he has been overseeing operations with revenue of about $1.9 billion.

Fonterra processes about 21 per cent of Australia's milk supply, although much of that is exported.

But years of severe drought have curtailed Australia's ability to export.

That has been a boon for New Zealand farmers, as it has helped push world dairy prices to record highs.

But it is also forcing Fonterra to rethink its Australian business.

"Strategically now we're focused much more in Australia on the consumer product market and the ingredient market," says Ferrier.

Ferrier is now downplaying the importance of a major Australian acquisition, despite last year being quoted in Australia as saying Fonterra had $2.4 billion available to snare "a big one" there.

He now says that although "encouraging growth" in New Zealand supply is likely to bring the extra equity needed to lift the gearing for a big deal, the A$2 billion figure is not necessarily aimed at Australia.

"There is nothing sitting in front of us now of that magnitude that we're looking at," he says.

Ferrier says the experience of losing National Foods to Philippines food and drink group San Miguel in 2005 gave an important lesson when it comes to any further acquisitions - such as Dairy Farmers, with its A$1.3 billion annual turnover.

Although Fonterra was prepared to pay $2 billion dollars for National Foods, Ferrier says that in hindsight this was too much and Fonterra "played it exactly correctly".

"We had a discipline that said 'this is the price we can pay' and we were very, very disciplined in not going above a level that we thought would not deliver shareholder value."

Although Fonterra received flak for losing that fight, Ferrier says two years later that the fact San Miguel's numbers for National Foods are down for the first quarter shows the A$1.9 billion it paid was too much.

"What it's telling us is we made the smart move by sticking to our guns."

And that indicates a cautious approach to Dairy Farmers.

Instead, Fonterra has been engaging in a piecemeal approach to expanding its brands, cobbling together companies such as Peters & Brownes in Perth, Bonland Dairies in Melbourne and Murrumbidgee Dairy Products in New South Wales. "We continue to see what we can do to roll up smaller players," says Ferrier.

It has also acquired a sales and distribution network from dairy co-op Norco, on the border of New South Wales and Queensland, which Ferrier says "is helping us stitch together a number of different consumer product activities".

But if Fonterra wants to fulfil its stated aim of becoming one of Australia's "few truly national dairy businesses", it will probably have to think bigger than that.

Apart from Dairy Farmers there is not much else around, says Joanne Bills, manager of strategic analysis at industry lobby group Dairy Australia .

Fonterra would need to target Australian Co-operative Foods, (ACF) the manufacturing and marketing part of Dairy Farmers that has been split off and is to be floated next year.

It has Cadbury, Dairy Farmers, Oak, Mastermaid, Farmers Best and Sungold in its brand portfolio.

"If Fonterra wants to consolidate over here and get those brands there's not a lot of other options," says Bills.

"Not a lot of other things are for sale."

She says there has been speculation in Australia about whether Dairy Farmers will actually make it to the stock exchange before someone like Fonterra comes along to scoop it up.

But even ACF is not without disadvantages.

Factors that could cause headaches for a potential buyer include its geographically spread-out supplier base - which ranges from South Australia to far north Queensland - plus clouds over the future of the supply agreements and the fact that the licensing arrangement for one of its major brands, Ski, is due to run out in 2012.

Bills suggests that Fonterra would more likely be interested in cherry-picking the brands without being saddled with manufacturing sites that tend to be in regions which are having problems with milk supply.

"A lot of farmers in Queensland and New South Wales are hanging in there until they can realise some value for their shares," she says.

"Then once the company's floated a lot of people will leave the industry at that point.

"The supplier base, already struggling in those regions, will be decimated even more."

But she concedes that after the National Foods loss, there is some sense in "taking the rough with the smooth" and getting in before someone else does.

One other option for expansion is Warrnambool Cheese & Butter Factory, Australia's only remaining ASX-listed dairy company, which Bills says lacks ACF's brand presence and which Ferrier has described as too export-oriented. But Ferrier has not ruled out making a play for Perfection Dairies, a small concern supplying a significant portion of the Sydney market, which Bills says might be able to boost its brand presence with Fonterra's clout behind it.

Although Fonterra has managed to turn around Bonlac Foods - which is in Victoria and Tasmania, the country's best performing regions - Bills says that by the time the Kiwi company took it over, it had lost quite a few of its larger farms, leaving it with a smaller average farm size and an older farmer base.

"They've struggled with it in terms of trying to encourage growth."

Even so Fonterra was still "kicking some goals over here", having achieved good penetration in the food service market, which had grown strongly as more people ate out, to the detriment of the retail sector.

Former Fonterra chief executive Craig Norgate believes Fonterra's objective in taking control of Bonlac was to stop it being a weak seller on the international market.

Now that goal has been met, he says, it is time to improve Bonlac's performance beyond the 8 per cent return on capital invested within the market last year.

It must also plug its gap in the ability to supply milk to supermarkets.

"If they'd bought National Foods they'd have have had the market leader," he says.

Dairy industry commentator Tony Baldwin says Fonterra's investments in Australia are rather messy, and says it is unclear what the market represents for the company.

"There's isn't a really clear or coherent strategy for what they're doing in Australia.

"Part of the problem is that Fonterra has had a series of relatively ad hoc joint venture investments in different parts of the world."

He said that when Fonterra went after National Foods, there was a view that a strong Australian base would give a platform for increasing its sales to Southeast Asia, but without a "particularly integrated business" in Australia that had yet to be developed.

And Baldwin says Fonterra's potential to capitalise on this renewed growth in higher value segments is constrained by its current capital structure.

National Bank rural economist Kevin Wilson says the combination of drought and dairy industry restructuring in Australia raised questions over how far milk production will recover in Australia, especially with the added possibility of rising water restrictions.

But Ferrier says that although less milk is coming out of Australia, it was still producing significantly more milk than it was consuming.

"No one is thinking Australia is going to get to a point where it has insufficient milk for the domestic market," he says.

Where the bloody hell are you?

* Years of severe drought have rendered the export side of Fonterra's Australian business "unfeasible", putting pressure on it to expand its brand presence instead.

* Fonterra has been acquiring brand capability through a series of smaller acquisitions around the country.

* But industry commentators believe a tilt at Dairy Farmers of Australia is the only way to achieve a truly national brand presence.

* Andrew Ferrier has backed down from comments in the Australian media last year in which he said Fonterra had A$2 billion to snare a "big one" in that market.

* He says National Foods' recent performance has vindicated Fonterra's decision in 2005 not to pay too much for the market leader in consumer products.

Making hay

The Big Dry that has decimated Australia's milk supply has driven the global dairy boom so strongly tipped in Fonterra's favour.

But the country hardly figures in Fonterra's strategy to cash in on conditions which have allowed it to forecast a $5.53/kg of milk solids payout for 2007/2008.

Fonterra chief executive Andrew Ferrier said to make the most of the good times, tipped to last into 2009, the co-operative was focusing on boosting milk supply from New Zealand and overseas.

"Where we may be doing less out of Australia, you'll see us doing more out of South America and other parts of the world."

Although high milk commodity prices were squeezing Fonterra's margins on its value-add business, the company was investing more heavily in research and development to create innovative products, an area where the Government's new R&D tax incentives would help.

"We've stepped up the advertising and promotional spend of our brand business and we're putting more money into R&D."

Fonterra was also "putting a lot of money" into boosting its ingredients business through its supply chains, citing the success of its formulated foods division, which make products such as infant formula.

Acquisitions was one way to grow, but Australia was not a focal point.

"If something's available in Australia, great. If it's not so be it. We're also in lots of other markets," he said.

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