NEW ZEALAND LISTENER

Fonterra's many masters

Co-op's different interests make life complicated.

By Pattrick Smellie In Business

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John Wilson's frustration that Fonterra is misunderstood is shared – by the very people his explanations would ideally target: its investors.

The largest interested group is its 10,500-odd dairy farmers, whose primary concern is the price Fonterra pays for its milksolids. The other group is non-farmer investors who can get in on the action with Fonterra through the Fonterra Shareholders' Fund (FSF), whose units trade on the NZX and give access to dividends based on Fonterra's earnings, but hold no voting rights.

Farmer shareholders are far less interested in Fonterra's overall profitability than whether their farms make money.

Private investors in the FSF are more interested in Fonterra's plans for growth. Those plans require new capital for investment, but farmer shareholders are neither able to provide enough of it, nor willing to let Fonterra take on new equity that would significantly dilute their ownership. Meanwhile, there's pressure on the co-op to keep farmers afloat.

“The use of scarce capital to support farmers can’t be helpful” for growth plans, noted First NZ Capital after Fonterra announced its results for the six months to December 31, 2015.

This is one of Fonterra’s “elephants in the room”. Another is the misalignment between the interests of its farmer shareholders and its manufacturing and processing operations.

When milk prices are low, farmers struggle, but Fonterra’s processing margins rise because the main input – milk – is comparatively cheap. When the milk price is high, manufacturing is less profitable but farmers do better. In an ideal world, these two would balance out and earnings would be fairly stable.

But life’s not that simple. For a start, milk production is a far larger business than manufacturing, so the two don’t naturally balance. And second, the manufacturing business doesn’t yet match the hype about value-added processing. Most of Fonterra’s production is low-value, commodity goods.

The other big problem is interpreting Fonterra’s financial results. Its performance measures are a continuous work in progress, making long-term and sometimes year-to-year comparisons difficult. The business is complex and each of its global operations has a different story. Farming in China is performing poorly, but food service is doing well. The ingredients business here is performing well, but struggling in Australia. Latin America is problematic.

In other words, the problem of interpretation is not all about townies’ ignorance. By design, the Fonterra behemoth is a complex beast.

Read more:

With continuing turmoil in the dairy industry, Fonterra chairman John Wilson says critics of our largest company have got it wrong.