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# Fonterra: Disappointment and soured dairy dreams. So what's gone wrong?

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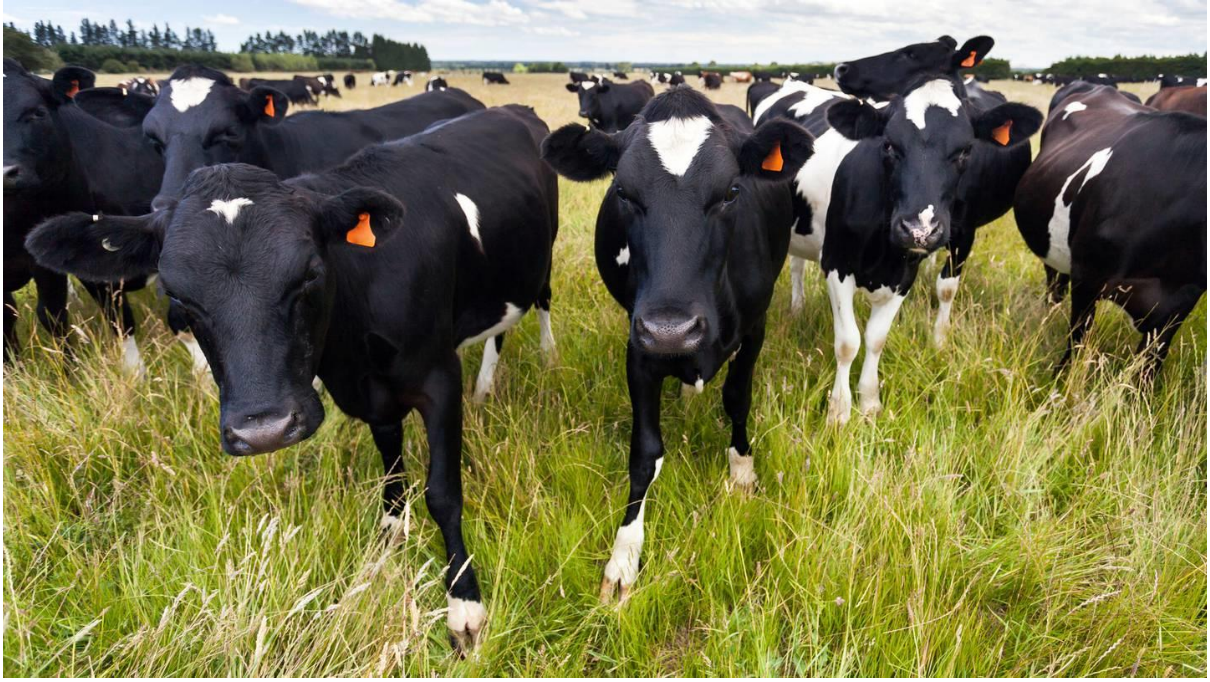


What's gone wrong for NZ dairy giant Fonterra? Photo / Getty Images

By **Andrea Fox**
Herald business writer



New Zealand dairy export goliath Fonterra had a silver spoon birth nearly 18 years ago. The offspring of a dairy industry super-merger which ducked the Commerce Commission on promises it would be a unique national economic champion, today Fonterra's looking a bit like the family's overweight, lazy teenager hogging the remote on the biggest couch in the room. And the credit card bills are coming in. Andrea Fox has an in-depth look at them in the first of a three-part series.

As big years go, 2001 was a monster.

Top of mind is what has come to be known simply as 9/11, a date that changed our world.

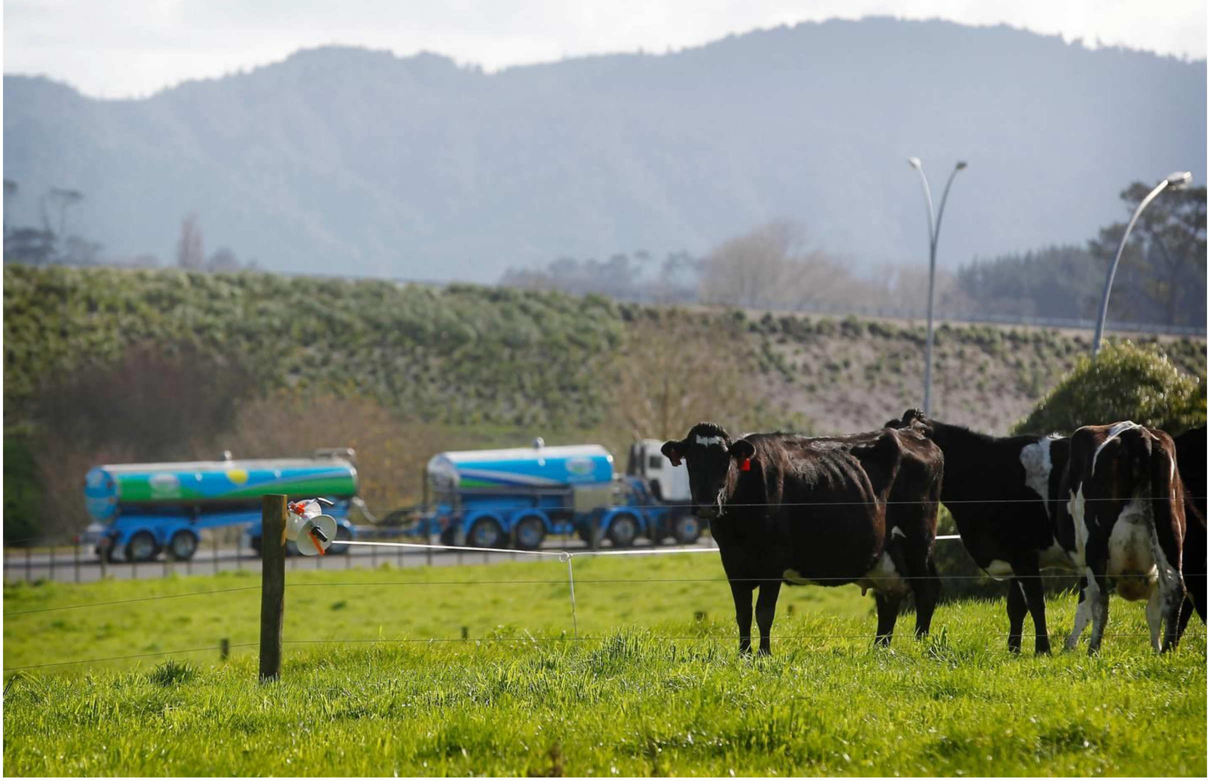
But other than the terror attacks on the US, the human genome sequence was revealed, 20,000 died in a huge earthquake in India, China entered the WTO, the Oklahoma city bomber was executed and the US refused to sign the Kyoto agreement on climate change, to name a few events.

In New Zealand, with the world still in shock from the sight of passenger jets being flown into New York skyscrapers, a dairy juggernaut business called Fonterra was launched.

Despite pledges the new enterprise would cross a brave new export frontier as a national champion for New Zealand, it is unlikely the October event registered in the Kiwi public consciousness.

But to the country's 13,000 or so dairy farmers, aspiring dairy exporters, regulators and a few economists, it was a big cheese of a deal.

Enabled by special legislation which also deregulated dairy exporting, Fonterra – from the Latin fons de terra meaning "spring from the land" – was the result of an industry mega-merger which swallowed dairy cooperative companies responsible for 96 per cent of New Zealand's raw milk collection and manufacturing, along with the multi-billion dollar single-desk exporter the Dairy Board.



CASH COWS? But Fonterra has failed to deliver on many levels.

Industry thinking was "united we stand, divided we fall" and Fonterra's privileged start came with promises from dairy tsars and farmer advocates that the new heavyweight would lift annual export revenues from about $12 billion to $30 billion within 10 years.

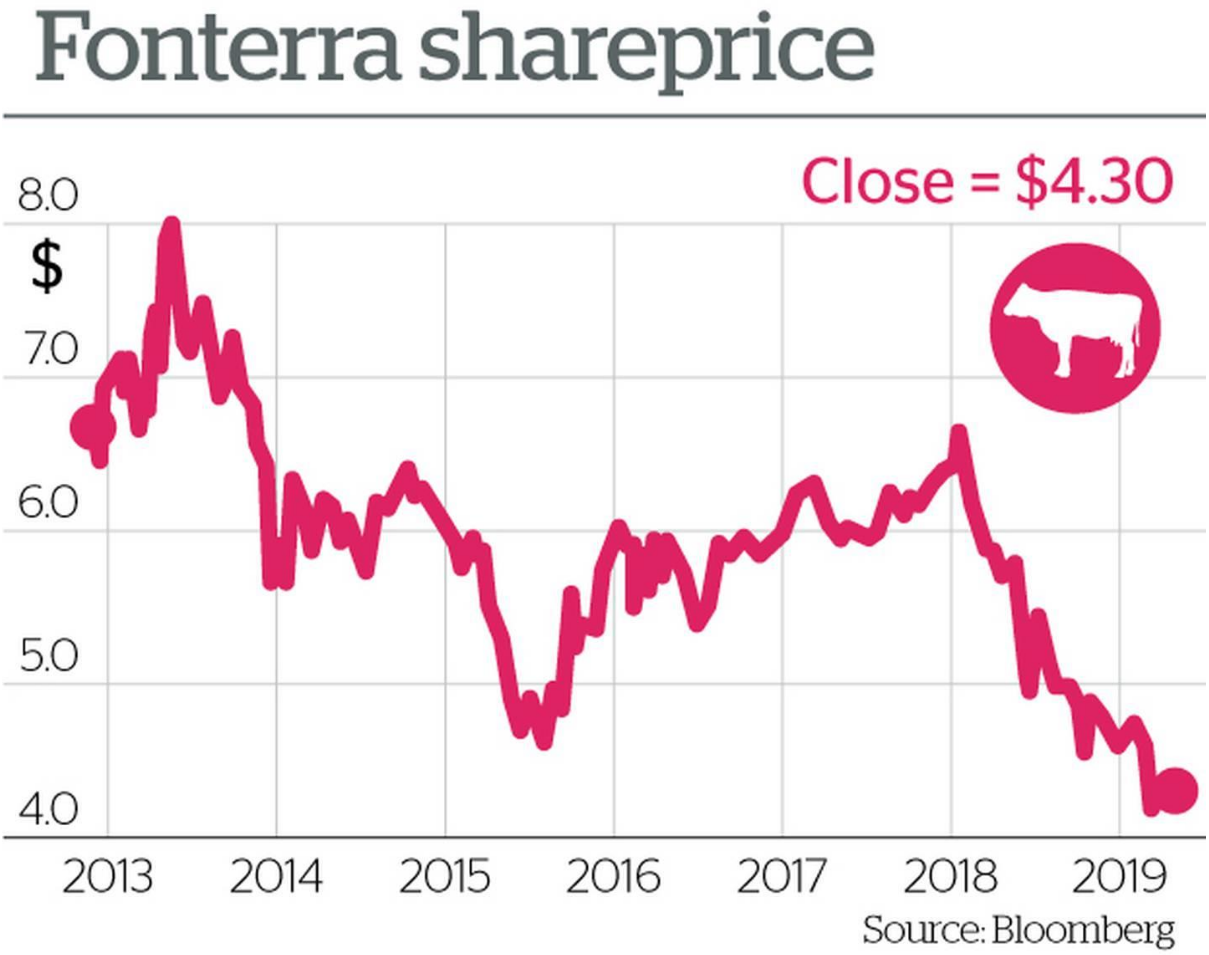
For farmers, who pay to supply milk to Fonterra through the purchase of shares, the carrot was they'd never again see a milk payout with a lowly $4 in front of it. (They did.)

Aside from assurances that Kiwi consumers would also benefit at the supermarket from resulting processing competition and rules were in place to prevent Fonterra running amok with its market power, there wasn't much to interest Joe and Jane Public in the new legislation, known as DIRA (Dairy Industry Restructuring Act 2001).

Fast forward 18 years and they are plenty interested, but not for the reasons the architects of New Zealand's biggest company hoped.

## An ugly bottom line

Last financial year Fonterra posted a historic first net loss of $196 million. Debt was $6.2 billion and more than $1.5 billion was written off its farmers' balance sheets – the effect of a 27 per cent fall in the share price and a constrained dividend. On top of that, the Fonterra board switched 5c/kilogram of milksolids from the farmer milk price over to its balance sheet to ease "a strained gearing position". Credit rating agencies sharpened their scrutiny.




The grim result pulled the scab off long-fomenting concerns about Fonterra's performance, business strategy and investment nous among its farmer-owners, economists, politicians and market analysts - concerns which had already captured headlines.

Now Kiwis, paying $5-plus at the chiller for butter and wondering if cheese is laced with gold, have joined the chorus of questioners.

How could a company that was handed a giant silver spoon, and, despite emerging competition, still handling 80 per cent of New Zealand's raw milk, be making such a hash of things?

Minds boggle that a New Zealand company could have such huge debt – largely the result of loss-making investments in China, a heavy international court penalty for Fonterra's false botulism contamination scare, and a brace of stainless steel plants thrown up to meet a milk production flood the company had encouraged.

With environmental regulations coming down hard on farmers and dairy farming debt of about $40 billion continuing to concern the Reserve Bank, that milk flood has eased, sparking speculation that Fonterra has, or will have, stranded assets.

And what happened to that magic figure of $30 billion annual revenue by 2011?

Last year, 17 years on, Fonterra's normalised revenue last year was $20 billion.

## China bombshells

Who on earth is making investment decisions at Fonterra?

Last year, it had to write off $439 million of a $750 million investment in Chinese baby food company Beingmate - an investment made only three years ago.

It has poured $788 million into developing seven dairy farms in China. They've been making a loss for at least five years. The loss for the 2019 half year was $21 million.

Also still fresh in memory is Fonterra's disastrous 43 per cent investment in Chinese state-owned dairy company Sanlu, centre of a 2008 melamine poisoning scandal which killed six children and made hundreds sick. Sanlu went bankrupt.

For Kiwis, it seems the only things on the up at Fonterra - apart from debt - have been pay packets and staff numbers, now at 22,000.


Former chief executive Theo Spierings. Photo / File
Former chief executive Theo Spierings, who left last year, took home $8.2 million in 2017, a year Fonterra posted a net profit drop of 11 per cent and an EBIT fall of 15 per cent.

Last year 6000 staff were paid more than $100,000 a year – 750 more than in 2017.

Fonterra has new leaders who have pledged to turn the ship around. Seasoned farmer director John Monaghan has succeeded the late John Wilson as chairman, and Kiwi Miles Hurrell is chief executive, on, we're assured, a much smaller salary package than Spierings.

New chief executive Miles Hurrell at the Fonterra offices on Fanshawe St, Auckland. Photo / File

## Time for change

So what exactly do they have to fix? What's wrong at Fonterra?

Agriculture Minister Damien O'Connor, whose first order on taking the job in 2017 was a review of DIRA and the state of industry competition, doesn't mince words.

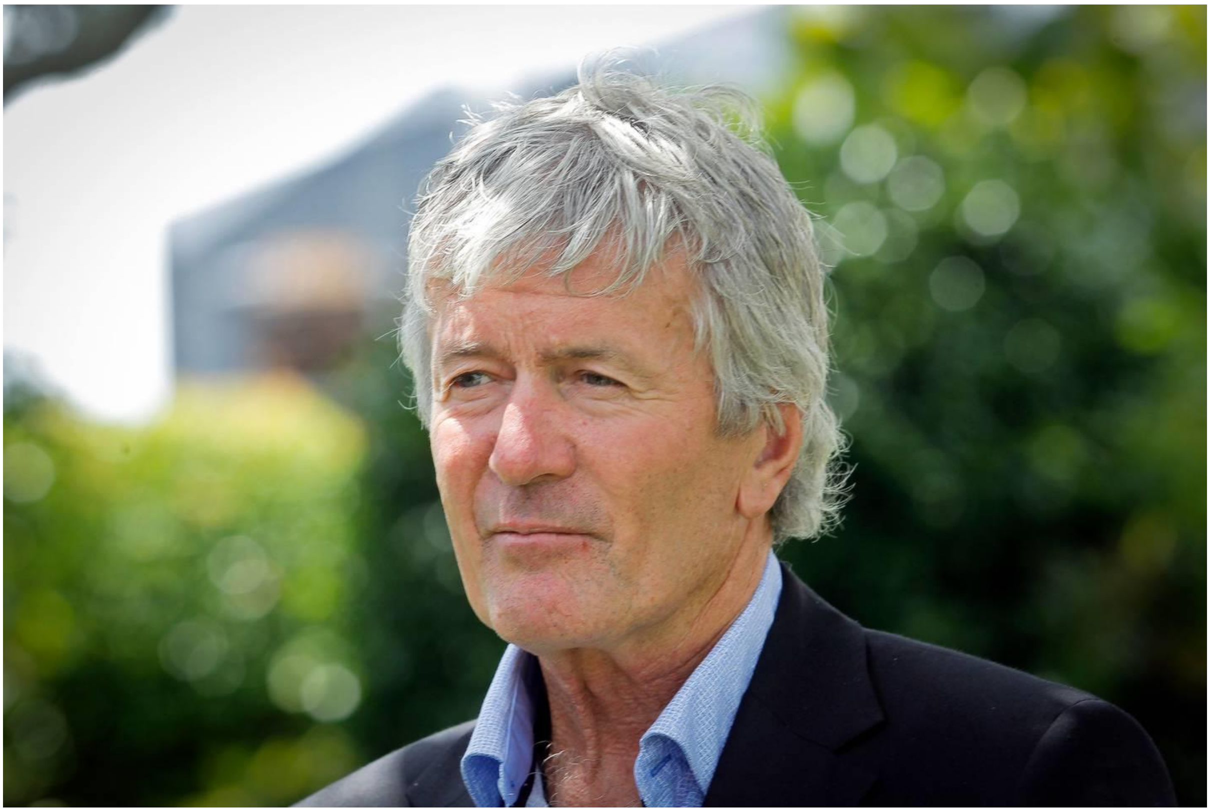
"Two core things. One is the level of debt, and second, the confusing signals coming from the company regarding its strategy and direction.

"They need to be clarified for shareholders, for unit holders, for the wider country, given Fonterra's importance to our future.

"It's our biggest and best company owned by New Zealanders and we've shown time and time again we're not necessarily very good at governing and managing big companies in this country.

"In part it's probably a casual approach by shareholders and analysts, who share a 'she'll be right' philosophy which doesn't keep the feet of governors and managers to the fire as much as they should be."

Don't look to the DIRA review outcome or the Government to fix Fonterra, O'Connor warns.


Agriculture Minister Damien O'Connor. Photo / File

"The review and the tweaks that may occur probably won't change the fundamental structure (of Fonterra) and the relationship that exists between Fonterra and its shareholders. It's therefore up to existing shareholders to decide what they want for their company.

"Ultimately shareholders have to pay more attention, take a greater interest and be more actively involved in Fonterra at every level."

The "structure" O'Connor refers to is today the subject of much juicy market conjecture by who the minister calls "commercial hyenas that have been circling Fonterra for a long time".

The collective cooperative strength of Fonterra dairy farmers has kept the hyenas at bay, O'Connor says, but industry insiders and market watchers say calls are heating up for Fonterra to be split up and a company, maybe listed, spun off it, open to outside capital investment to chase high-value product markets.

Brian Gaynor, of Milford Asset Management, says even major Fonterra shareholders are telling him it's time for change. The Herald has heard similar comment.

## Breaking up hard to do

Breaking up Fonterra in the pursuit of capital is not a new idea. Former leaders have floated it. The notion was rejected by shareholders – their major concern, and still likely to be, was how do they retain control of the breakaway?

Realistically, they probably can't.

Fonterra is a cooperative, 100 per cent owned by about 10,000 farmers these days. There are myriad views why it isn't performing but general agreement that lack of capital for growth is a major.

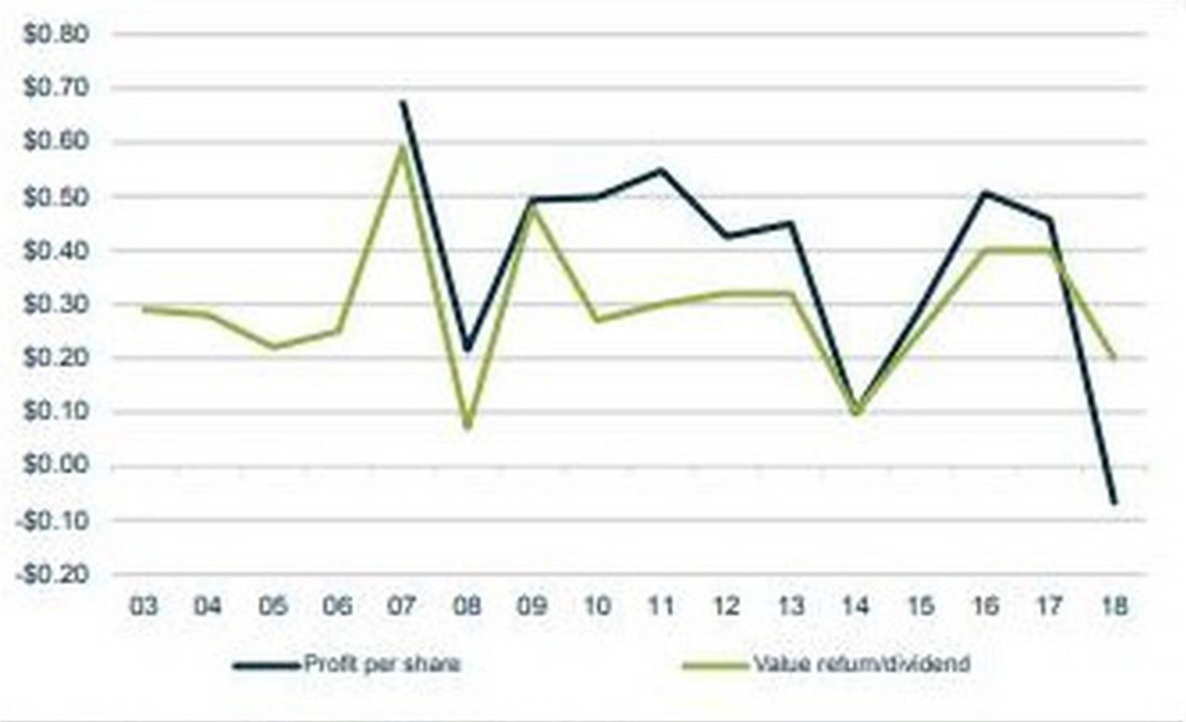
It's a problem that's contributed to the likely imminent sale of the Westland dairy cooperative to China's Yili. A sale will leave only two dairy cow co-ops - Fonterra and Waikato's highly successful, but in comparison, minnow-esque, Tatua.

In a bid to retain capital and deter farmers from selling their shares to defect to emerging competitors which don't require shares to supply, Fonterra in 2012 launched Trading Among Farmers (TAF). It saw Fonterra shares listed on both sides of the Tasman via the Fonterra Shareholders' Fund (FSF) and dividend-carrying, non-voting units in those shares offered to outside investors.

While chairman Monaghan says TAF has been successful in stopping capital washing in and out of the balance sheet, he's a lonely voice. The shares listed with a hiss and a roar at $6.08, as investors seized a first opportunity to participate in the performance of the world's largest dairy exporter.

Lately the shares have been trading around $4.32. Dividends have fluctuated from 40c to 10c per share. No dividend was paid in the first half of 2019. Prospects of a full year dividend aren't bright.

**Figure 6: Profit per share and value return/dividend per share, NZ$/share**




Source: Company data, First NZ Capital estimates

Among the disillusioned is Craigs Investment Partners, which last year ditched FSF, citing volatile earnings, poor cash generation, limited transparency and lack of improvement despite capital expenditure of more than $3 billion in the previous eight years.

Craigs also noted the tension Fonterra's oddball capital structure creates between shareholder classes.

As a cooperative, Fonterra's reason-for-being is to pay its farmers the highest possible milk price each year. This is the priority call on earnings.

FNZC managing director of institutional research Arie Dekker says TAF actually allowed Fonterra to take on extra debt.

"Fundamentally it did not provide Fonterra with a capital structure for the growth it looked to be targeting under the previous volume/value strategy of the last five years."

Dekker says Fonterra's limited earnings retention to satisfy farmers' priority demands and its access to capital being limited to what farmer suppliers can provide "isn't necessarily a bad thing but the strategy needs to be consistent with the capital structure constraints".

As even the staunchest of cooperative supporters, Fonterra Shareholders' Council chairman Duncan Coull says, "How on earth can you grow a value-added business when you starve it of capital?"

"My personal view is it's no wonder it hasn't performed ... given we as investors in the business expect that most, if not all, of the profits are paid out every year."

## View from the top

Monaghan defends criticism the Fonterra board hasn't had a solid earnings retentions policy.

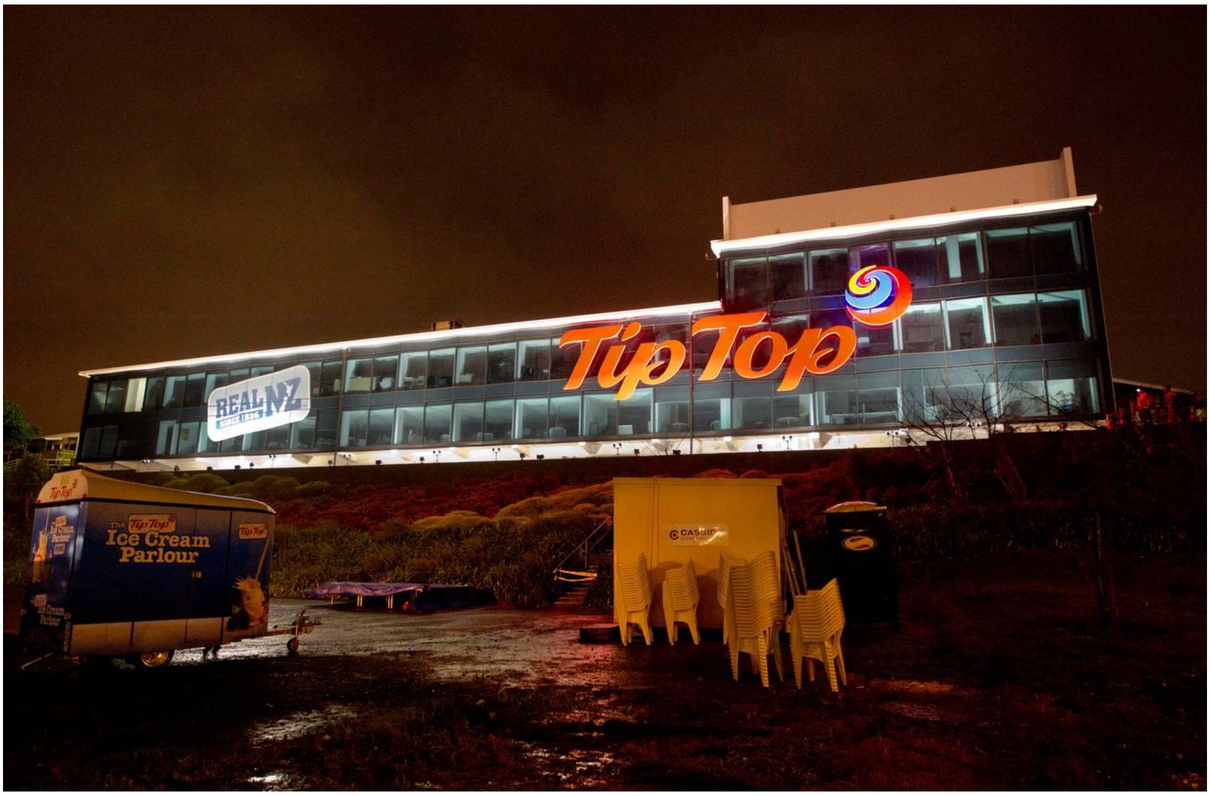
For "some time" policy has been to retain 5 to 35 per cent of earnings, he says.

In a joint interview, Monaghan and Hurrell said Fonterra's greatest challenges are reducing debt and rethinking its business strategy.

Monaghan: "There are a number of things on our agenda and we've been quite clear about the immediate challenges – reducing debt and getting the gearing ratio back into policy, and getting our capital expenses and operating expenses back to 2017 levels."

Hurrell says a major review of strategic direction is "well advanced".

Assets may be sold. Icecream maker Tip Top is a contender.



The Auckland Tip Top manufacturing business is on the block. Photo / Steven McNicholl
"One of the key points about selling assets is to get our business more targeted and focused. Tip Top as an example has very little milk in it and while it's a great company here in New Zealand, it's a confectionery company as opposed to a dairy nutrition company."

The Kapiti icecream business was also in the mix but the Kapiti brand will be retained, Hurrell says.

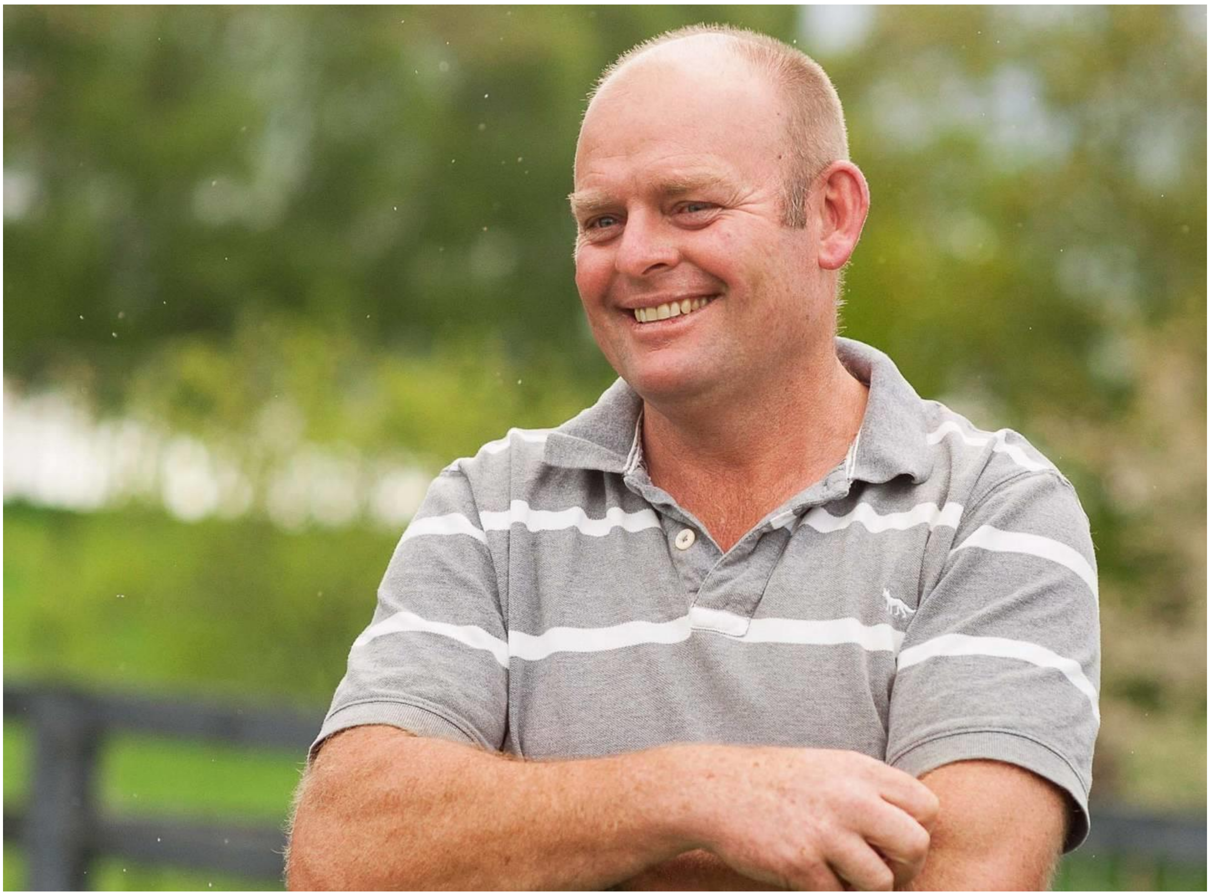
Asset sales should not be confused with Fonterra addressing its capital squeeze, he says.

"Selling of assets is getting our portfolio into a more aligned shape with the strategy we currently operate under but also in preparation for a new strategy.

"One of the areas of concern I have … is we do a lot of things in a lot of markets. Some of them very well and some of them poorly.

"We are spread too thin."

FNZC's Dekker says Fonterra has disappointed with its inability to increase earnings and share value over a long period of time - despite an increased pool of New Zealand milk supply in the past 10 years and "reasonably material investment over and above what is required to maintain and support" that supply.



Fonterra Shareholders' Council chairman Duncan Coull. Photo / Supplied

"Complexity appears to be an issue, as does a series of reasonably material - for Fonterra's size - offshore investments that have not performed well."

Hurrell disputes popular opinion Fonterra is still a commodity seller that has failed to add value to its products.

"We need to be very clear that less than 20 per cent of our milk is sold through Global Dairy Trade (commodity auction platform).

"Beyond that you could argue that a lot of milk is above the GDT price so we shouldn't assume value-add has consumer packaging on it."

Fonterra sells high-end ingredients to pharmaceutical companies around the world.

"To my mind that's value-add. (Our) food service business is value-add. Of course there are ranges of value-add. At one end of the spectrum you might have high-end consumer product but that takes a lot of investment in advertising, promotion and brand awareness so you need to think hard about which markets you go into."

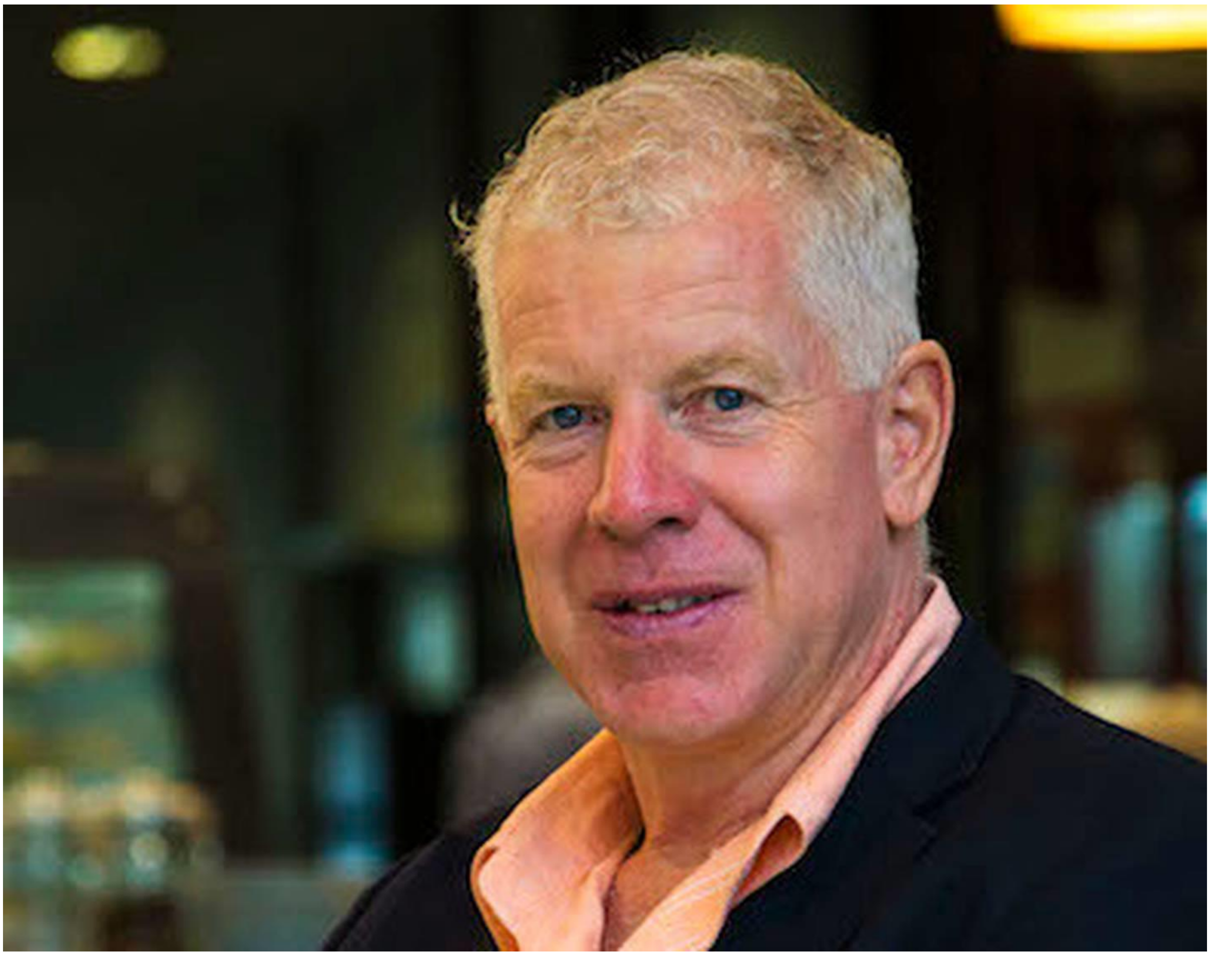
Monaghan says the next announcement and any conclusions from the review will be in May, with full details revealed at financial year-end.

## What the law says

For Massey University business school senior lecturer Dr James Lockhart, Fonterra's problems are the milk price/earnings retentions dilemma – and its attitude.

"Fonterra is a creature of statute. It's almost impossible to uncouple it from DIRA though you can uncouple its strategy in both the domestic and international markets and how it plays the game," says Lockwood, who believes DIRA is a "magnificent and insightful" piece of legislation.

To counter Fonterra's raw milk market dominance, DIRA's architects obliged it to accept all milk offered to it and to sell raw milk to competitors at a regulated price. The former protects remotely located farmers whose milk pick up could have been dropped by the mega-merger company. The latter obligation now only applies to small and start-up companies. The current DIRA review is addressing both obligations.



Fonterra is a 'creature of statute', says Massey University senior lecturer Dr James Lockhart.

"Fonterra uses DIRA as an excuse for their strategy (not working) and for their pricing. They say we have to do this or that because of DIRA and that's grossly misleading. That's when Fonterra shows its ugly side," Lockhart says.

"The list of their bad investments is getting longer and longer. It's terrible and inexcusable and supplying shareholders and arguably other shareholders should be calling for heads."

Investment banker Troy Bowker says Fonterra's "ongoing" problem of lack of access to capital is even more concerning than its debt position.

The executive chairman of Caniwi Capital and former head of asset and structure finance at HSBC London and New York says Fonterra's leverage at 48 per cent is high compared with 42 per cent in 2014, an increase of $1.5 billion in five years.

"Looking at comparisons with other multinationals such as Nestle (at 29 per cent), Fonterra has much higher leverage."

But Bowker, who is plugged into banker circles, says the debt position isn't too uncomfortable given the size of Fonterra's balance sheet and diversity of earnings and he doesn't think credit rating agencies will be "too stressed".

"There's still way too much corporate excess at Fonterra but I'm pleased to see the recent exits of some highly paid, badly performing senior managers."

Former deputy Fonterra chairman Greg Gent, a farmer-shareholder, says cooperatives work well where they are "transactional".

"That is, a dollar in today is a dollar out tomorrow. Where co-ops move up the value chain problems appear. Not having a share that reflects true value means that new entrants free ride on earlier investments. During the years of heady milk growth in New Zealand that would have been a huge problem if a fair value share had not been put in place.

"Tatua dealt with this problem by being closed. The inherent value they have built in their co-op is reflected in the value of their farms. Those farms carry a large price premium."

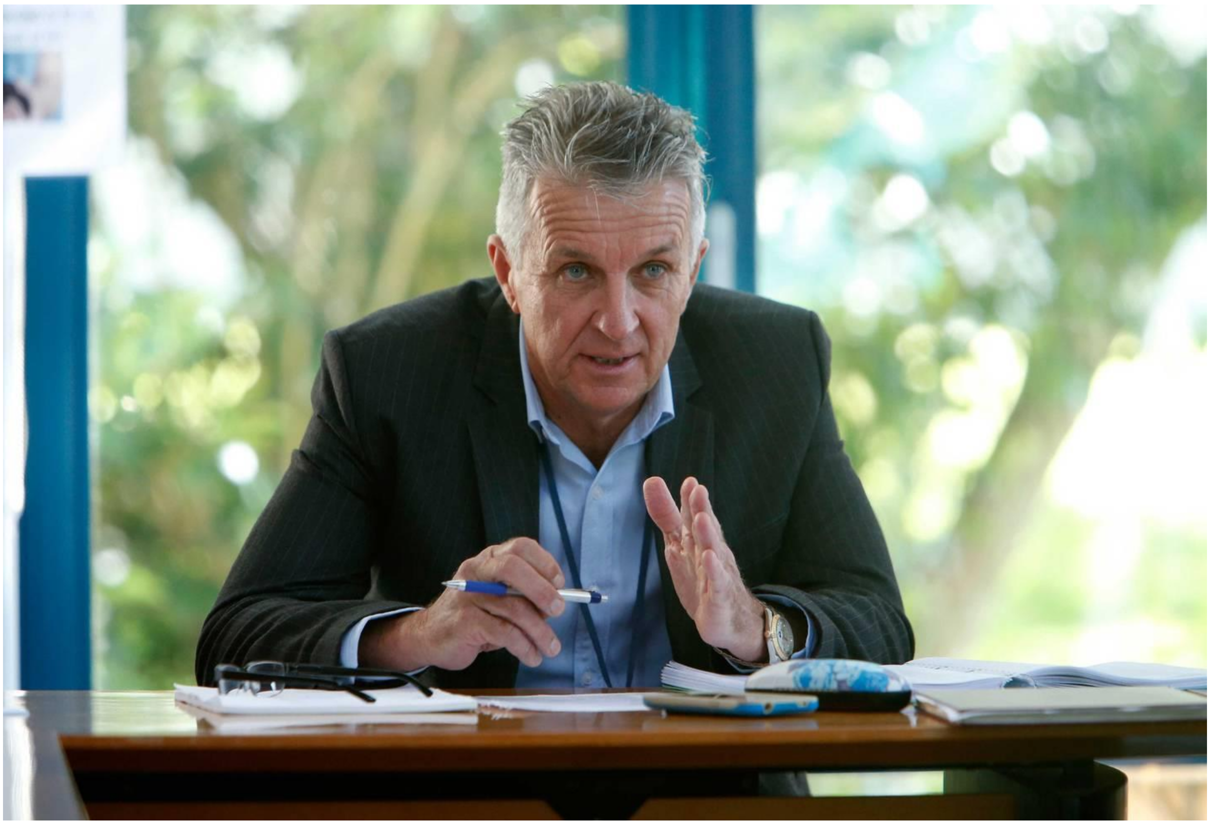
## Betting the farm

Gent, who with Fonterra's biggest shareholder and former director Colin Armer in 2015 led a successful campaign to improve the governance model at Fonterra, says a number of "huge investments by Fonterra have effectively bet the farm".

"They have not paid off and have taken away billions of dollars of Fonterra farmer equity."

What's wrong with Fonterra is cumulative poor performance which has resulted in a company with too much debt, says Andrew Watters, chief executive of MyFarm Investments and a Fonterra shareholder.

"It's come at a bad time because farmers also have too much debt. We are weak and vulnerable.


Former deputy Fonterra chairman Greg Gent. Photo / File
"That's either because of poor strategy or poor execution of that strategy."

Watters says he's worried about Fonterra's Australian business.

"There's declining milk supply and a lot of competition for milk. Australia's getting drier and permanent crop farmers in the north of Victoria are outbidding farmers for water.

"There's a lot of competition among the big multinationals and for some reason Fonterra doesn't have an overly positive reputation among suppliers as I understand it.

"I would certainly like directors to reassure us about the future of that part of the business."

Federated Farmers vice-president Andrew Hoggard, a Fonterra farmer-shareholder, says the company has "legacy issues in terms of debt, investments and possibly a strategic direction that was not lined up with farmers' thoughts".

By that he means the Wilson-Spierings strategy of making Fonterra a globally significant company by establishing milk producing pools in countries such as China.

He also detects a groundswell of demand that Fonterra change – but not in the way minister O'Connor's commercial hyenas would wish.

Fonterra Chairman John Monaghan. Photo / File

"A lot of farmers feel it's time to be a kick-arse New Zealand cooperative and sell the story of New Zealand milk and all its grass-fed attributes grass-fed attributes.

"When you're effectively putting Australian, Sri Lanka, Chilean, New Zealand and Chinese product all under the same brand you can't really sell the story that New Zealand's Anchor brand or whatever has all these great grass-fed attributes."

## Governance gripes

Some industry people who spoke on condition of anonymity said poor governance was part of Fonterra's problems.

"I think we've gone backwards governance-wise," one said.

"In the Dairy Board days, cooperative companies appointed one of their own onto the Dairy Board. That went a long way to ensuring their best went onto the Dairy Board. That's gone and we are seeing the results."

Some noted that neither Monaghan nor Wilson had chaired a company of material size before taking the top seat at Fonterra.

Fonterra's constitution says the chairman must be a farmer-shareholder. The company has 11 directors – seven elected by farmers and four independent and appointed by the board.

"A farmer-heavy board of directors is probably ok at governing a milk processing cooperative. Their ability to govern a fast moving consumer goods company treading in 94 countries on the other side of the world is questionable at best," was one observer's opinion.

"The current pool of directors would have little feel for the world and no skill at all to foot it with the boards of Danone, Nestle and Kraft. That leads to board capture by executives."

Monaghan responds: "In these roles there's no shortage of advice from a full range of commentators.

Former Fonterra chairman John Wilson. Photo / File

"My observation on Fonterra governance present and past is we've been able to attract top end external independent directors. They wouldn't come onto a board unless they thought it was operating at world-best governance standards."

Monaghan says he's been well-groomed for the job of chairman.

He says he understands the cooperative intimately "from grassroots level" and has visited all Fonterra's overseas markets over many years, including leading eight delegations.

"A lot of commercial and soft skills are required to go into this role."

Another sector observer suggested that in the rush to condemn inexperience among farmer directors for Fonterra's woes, few questions had been raised about the role and competence of directors appointed by the board from the so-called commercial world.

"Where were their voices in all this? Why aren't they being questioned too?"