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Fonterra: In defence of the cooperative model

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There's a strong economic case for Fonterra remaining a cooperative. Photo / 123RF

By **Andrea Fox**
Herald business writer

Nearly two decades on from its creation, Fonterra is still handling about 80 per cent of all New Zealand raw milk. But is it time, as some critics say, to chop up this $20 billion beast and create a separate discretionary investment vehicle to chase the money needed to hit the high value, high earning branded consumer product markets? In the second part of her series, Andrea Fox runs the ruler over the cooperative model.

Fonterra's architects got a lot of backs up when they side-stepped the Commerce Commission, claiming their plan for a super-cooperative to take on the world was beyond the competition watchdog's scope.

Instead they went directly to the Beehive. The result was the DIRA, the Dairy Industry Restructuring Act 2001. It birthed a cooperative dairy industry mega-merger, deregulated dairy exporting and encouraged new manufacturing and export competition, while setting some onerous rules to rein in Fonterra's market dominance at home.

It's long been a gripe in the $16 billion dairy sector that neither the commission, which polices Fonterra through DIRA and the Commerce Act, nor the Kiwi public, really understand the cooperative business model.

Fonterra CEO Miles Hurrell. Photo / File

The commission seemed to confirm this recently when it said Fonterra was setting the price it pays farmers for milk too high. This was because it was estimating on the low side, cost of capital, said the commission.

Eyes rolled at this because Fonterra's main job as a cooperative 100 per cent owned by its 10,000 shared-up farmers is to pay them the highest milk price possible.

That's just a fact for cooperatives.

But it's also a fact this constitutional obligation is proving problematic for New Zealand's biggest company and is stoking the critical scrutiny its financial performance is under from all sides these days.

Because it must pay out the maximum possible milk price, when the balance sheet is under pressure debt climbs and there may be only crumbs left to pay dividends.

And Fonterra is answerable to more than its farmer-shareholders.

In a 2012 quest to retain and attract more capital, it listed farmer-owned shares and offered dividend-carrying, non-voting units in those shares to outside investors.

Shareholders of all stripes are pretty grumpy at Fonterra right now. The share price has slumped since 2012, dividends have been volatile and this financial year there's a strong possibility no dividend will be paid.

The Achilles heel of this cooperative dairy nutrition multinational is retaining and accessing enough capital to grow.

Nearly two decades on from its creation it is still handling about 80 per cent of all New Zealand raw milk. The trade-off for the legislative pass was that it would be a national champion for the economy, a world-beating exporter of added value products, a rival perhaps even for Nestle.

The jury's in and the verdict – hardened by the posting of a historic $196 million loss and $6.2 billion debt last year – is that Fonterra isn't performing as it should be.

It's time, say the critics, to chop up this $20 billion company into a cooperative to do what it's good at which is the basics - first stage milk collection and big plant processing - and a separate discretionary investment vehicle to chase the money needed to hit the high value, high earning branded consumer product markets.

Not so fast

The argument for breaking Fonterra up tends to ignore the fact that Fonterra already does add value to milk in its global ingredients and food service businesses – an area in which it is recognised as a top operator.

Only 20 per cent of all the milk it handles is sold as straight commodity products on the Global Dairy Trade auction platform each month, says chief executive Miles Hurrell.

It also overlooks two other inconvenient facts.

Fonterra leaders have tried to lead its farmer-owners down this path before. They resisted, fearful of losing control of a business built with the capital of generations before them.

The compromise was Trading Among Farmers (TAF) which introduced the Fonterra Shareholders' Fund (FSF) and the listed units. It also introduced tension between Fonterra's investor classes. (Farmers generally speaking care more about the milk price – unit holders want robust dividends).

Fonterra chairman John Monaghan says the scheme has been a success in that it's curbed loss of capital from the balance sheet through share redemptions.

But the sharemarket – and some major farmer-shareholders - have all but written it off.

Craigs Investment Partners research analyst Mohandeep Singh says the performance of the FSF has been "lacklustre at best".

Craigs last year dropped FSF from its New Zealand equities portfolio.

Agriculture Minister Damien O'Connor has warned the Government won't be helping Fonterra out of its tight spot. That's a job for its leaders and shareholders, he says.

So is being a cooperative Fonterra's real problem? And aren't producer-owned cooperatives a rather quaint, old school business model?

The answer to both apparently is no.

Agriculture Minister Damien O'Connor. Photo / File

There's no shortage of opinion that in fact, Fonterra is New Zealand's biggest company by a country mile and the world's fifth largest dairy company because it is a cooperative.

Minister O'Connor says Fonterra's world reputation as a New Zealand-based and supplied company is thanks to its cooperative model legacy.

"It's our flagship company around the world. And it's built off the reputation of the former (cooperative) Dairy Board, and is still known as an aggressive marketer and successful player in international dairy markets."

Fonterra sets the pace

Back home, Fonterra the cooperative is seen as essential to the economy as a milk price setter.

As the big cheese of the New Zealand dairy sector, it sets the national price benchmark for raw milk.

This no doubt keeps Commerce Commission scrutiny sharp and really irks smaller manufacturing competitors which have to match or better Fonterra's price to attract milk supply.

As former Fonterra deputy chairman and shareholder Greg Gent puts it: "Public companies will only pay what they have to get milk and they pay at the cooperative price.

"Look around the world – where there are weak cooperatives, public companies make a lot of money. Where there are strong cooperatives, they don't."

Former Fonterra deputy chairman and shareholder Greg Gent. Photo / File
Why should Kiwis care about this?

Because according to Fonterra's sums, dairying returns more than $8 billion a year to rural communities and towns.

Massey University business school senior lecturer Dr James Lockhart says a critical role of primary sector cooperatives is to set price.

"And in setting price, if your cooperatives are sufficiently influential and sufficiently powerful – not necessarily big – it is critical they set a price that provides a return to their suppliers so that suppliers exceed the average weighted cost of their (own) capital.

"In doing so proprietary companies have to meet that price. That's why we need a strong Fonterra."

But the cooperative business model faces a dilemma, says Lockhart, who teaches and researches corporate strategy and governance.

They have to generate adequate funds for investment off-farm too.

"That's where the real tension lies for the boards of these cooperatives – how much do they have to return to farmers and how much do they retain for their own investments?

"It looks as if Fonterra has been giving too much back to farmers and not retaining enough – or what they have retained they have invested very poorly."

Chairman Monaghan is "bemused" by comments Fonterra pays too much for milk."

Fonterra chairman John Monaghan. Photo / File

"It's the core purpose of the co-op – it's a 150-year-old model that's delivered year in year out for our farmer-shareholders.

"We've recently had some high-profile failures. All businesses go through a cycle especially when they're exposed to global influences, and particularly in our case when we export 95 per cent of our product.

"The model is so farmers can control their own destiny."

Chief executive Hurrell: "The strength of the business is largely the heart of the cooperative structure and the nature of the business in the way our funds are repatriated back into the New Zealand community."

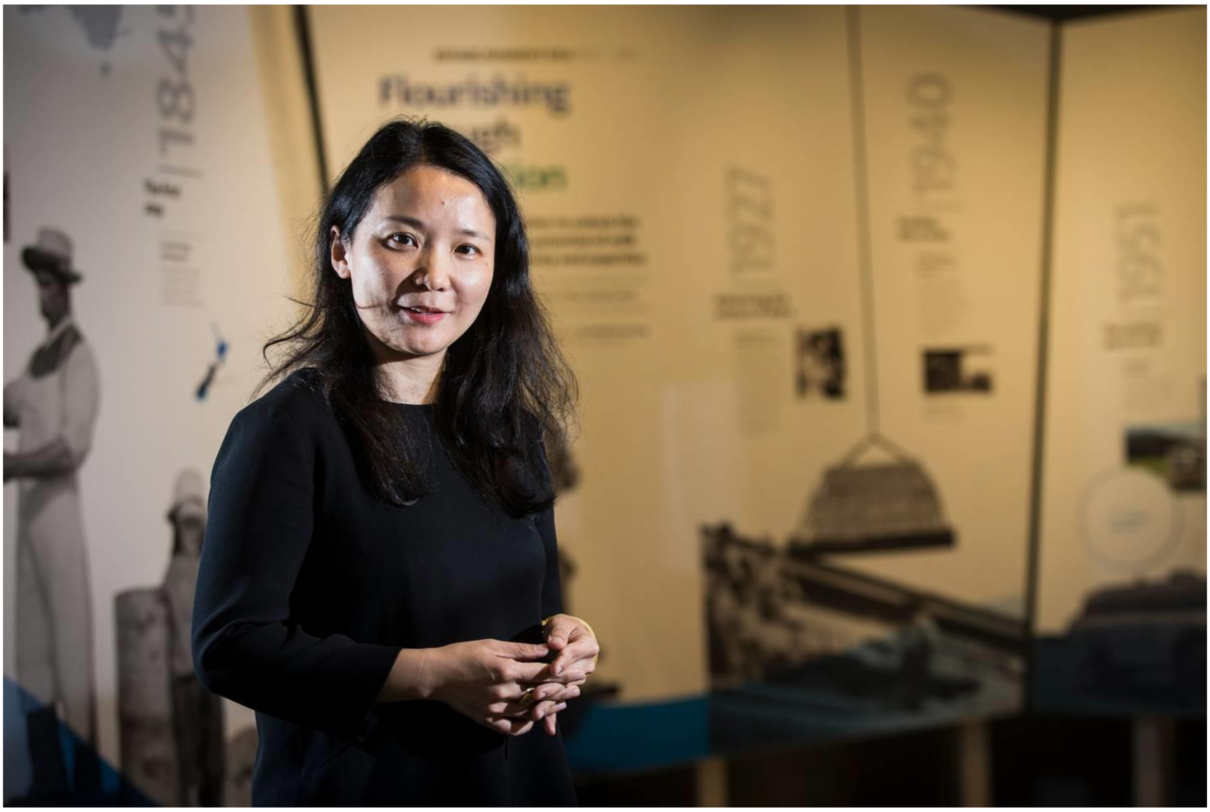
Monaghan says the cooperative model has delivered "tremendous value" to rural communities and the economy.

"When we started, Fonterra farmers were paid half of what our global peers got. New Zealand dairy farmers are now paid a price that is ahead, or sometimes similar to those competitors overseas.

"That is a huge success and it wouldn't have happened without a strong cooperative like Fonterra.

"It's clear we haven't got every decision right and we've been very clear we are looking that the business end to end … but we've had some successes too.

"We talk about our problem child Beingmate relentlessly, but China would be one of our most obvious successes. I can't think of another Australasian business that's built a $4 billion-plus revenue business in China in the time Fonterra has, despite Beingmate."



Fonterra managing director Greater China Christina Zhu. Photo / File
Monaghan says two things are always on the cooperative board agenda: capital structure and governance.

"I look back at TAF and it's been tested through some difficult business cycles. Look at where the milk price has been – it's stood the test of time."

Danger signals

The likely sale of West Coast dairy cooperative Westland Milk Products to Chinese giant Yili hasn't done much for NZ Inc. confidence in the cooperative business model.

If the $588 million buyout deal goes ahead, Fonterra and Waikato's highly successful small Tatua will be the only two dairy cow cooperatives left in the country, where once there were dozens.

Westland hasn't been paying its 420 or so farmers a competitive price for several years. The kitty is stretched, the company is heavily in debt and the banks are breathing down its neck.

Some of its farmers are still on their knees from the last global milk price slump, and feeling the heat from bankers.

Westland and Tatua did not join the 2001 industry mega-merger which created Fonterra.

Minister O'Connor says Westland "is a stark reminder to Fonterra shareholders that there are always people circling their company who would be very happy to buy it in part or in whole".

"They can be compared in many ways – Westland is just a microcosm of the larger Fonterra."

Federated Farmers vice president and Fonterra shareholder Andrew Hoggard says it's plain to see what happens to farmers without a cooperative.

"You just have to take a trip to Australia or the UK to see what happens when you get rid of co-ops. You suddenly find yourself at the mercy of private companies and supermarkets.

Federated Farmers vice president and Fonterra shareholder Andrew Hoggard. Photo / File

"To see what Fonterra gives us, just go back to why farmers joined together in the first place to pool their milk and sell it together. It gave them some control so they weren't getting played off one against the other. There was the sharing of resources to get the product to market.

"With milk you've got to get it off the farm every day or every second day. You can't stick it in your woolshed and hope prices are going to improve and then put it on a truck and send it to town. You need the surety of pick up.

"Due to being a co-op and its size, Fonterra not only gives that surety to its suppliers, but to virtually every other dairy farmer in the country."

The co-op model keeps "people in line", says Hoggard.

"Look at the independent companies bleating about Fonterra paying its farmers too much. You can guess what would happen if Fonterra wasn't around."

He says the carrots in Yili's offer for Westland are a good example of why New Zealand needs a strong dairy cooperative.

Yili is guaranteeing to match Fonterra's milk price for 10 years and to pick up the milk of all existing suppliers – no matter how remote they are.

So is the dairy cooperative business model in peril?

Hoggard suggests yes, if Australia is any example.

"It was predominantly co-ops there and they were just whittled away. There's definitely a risk that people under short term pressure look for solutions."

Fonterra the cooperative is seen as essential to the economy as a milk price setter. Photo / File

Bank pressure can lead to indebted farmers selling their cooperative shares and supplying private companies which don't require suppliers to buy shares, he says.

"Or they'll say if you want to do an expansion, 'we're not going to give you any money, sell some shares'."

Greg Gent says the reason the cooperative dairy industry was founded nearly 150 years ago is as relevant today as it was then.

"Farmers needed to get milk into a non-perishable state so they have some ability to trade it and play markets, rather than be a price taker at the farm gate.

"New Zealand needs at least one large co-op. In any country in the world the co-op is the benchmark for the price of milk."

Co-ops are big business

On the global stage, the success and size of the cooperative business model is not to be sneezed at.

According to the World Cooperative Monitor, last year the total turnover of the world's top 300 cooperatives was US$2.6 trillion (NZ$3.9 trillion).

More than 1400 of the cooperatives surveyed had revenue of more than US$100m.

One of the world's biggest financial institutions, Rabobank, is a cooperative.

Monitor said 32 per cent of the top 300 cooperatives were in insurance, 35 per cent in agribusiness and 19 per cent in retail and wholesale trade. The remainder were involved with banking, industry and utilities, health and education and other services.

The world's biggest cooperative based on revenue was France's Group Credit Agricole.


There's a strong economic case for Fonterra remaining a cooperative. Photo / 123RF
Rabobank, which ranks Fonterra fifth biggest dairy company in the world, in a recent report said cooperatives still dominate dairy world rankings but "are also challenged".

Cooperatives occupied 4th through 7th positions of the global dairy top 20.

Together the four largest dairy cooperatives account for nearly US$54b in turnover in 2017, more than double the annual revenue of Nestle, number 1 spot holder.

"Dairy cooperatives operate in a challenging economic environment," said Rabobank.

"Dairy farmers struggle with creating 'farmholder v shareholder' value.

"This is allocating capital/investing in their farm operation, rather than growing their cooperative's shareholder value through M&A or plant expansions.

"The expectations of many farmer-cooperative members to receive the maximum milk price has left the cooperative with limited funds to support future growth."

Also, dairy cooperatives faced a constant battle to find the right/and or innovative structure to help access outside capital, Rabobank said.

And the high profile failure of Australian cooperative Murray Goulburn last year had made cooperative directors more risk averse.