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Time's up: Is this Fonterra's sink or swim moment?

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There have always been plenty of opinions on how New Zealand's biggest company could be better run. Photo / File

By **Andrea Fox**
Herald business writer

New Zealand dairy export goliath Fonterra had a silver spoon birth nearly 18 years ago. What's happened since then? Andrea Fox says it's time for some radical thinking in this, the last piece of a three-part series.

Somewhere, sometime, in the past year, the national conversation about Fonterra took a dark turn.

There have always been plenty of opinions on how New Zealand's biggest company could be better run – it's a creature of statute so Kiwis feel entitled to comment – but the tone of the debate has shifted to how many years Fonterra has left.

Economist Peter Fraser reckons this is "the Kodak moment" for Fonterra and the New Zealand dairy industry as producers of commodities and ingredients.

Also blunt is investment specialist Brian Gaynor, a director of Milford Asset Management, who says the writing could be on the wall for Fonterra in 10 to 15 years if its performance doesn't improve now.

And Agriculture Minister Damien O'Connor pulls no punches.

"There have been commercial hyenas circling Fonterra for a long time. (Its farmer-owners) have to wake up to that reality… that it's the collective strength and wisdom of dairy farmers that keeps those hyenas at bay."

"There's an emerging reality that with corporate farming and outside players in the dairy industry, the cooperative philosophy is being diluted to the point where there are risks to Fonterra from its shareholding base."

There's been growing and vocal dissatisfaction with the performance of our supposed national export champion for several years – but notably lately among the cooperative's dairy farmer-owners as well as the usual suspects in competitor, economic and political circles.

Lately the chorus "something's got to change" has taken on an edge.

Concerns came to a head last year that nearly 18 years after its creation from a cooperative dairy industry merger enabled by special legislation, Fonterra is a lumbering, capital-starved and costly market engineering experiment that's failed. A domestic market gorilla better known for its salary excesses, some disastrous overseas investments, a plunging share price and patchy dividends than stellar export earnings growth.

The tipping point was its 2018 financial result – a historic $196 million net loss and $6.2 billion debt.

Former chief executive Theo Spierings, who took home $8 million in 2017, a year the company's books showed little reason to celebrate, exited last year to the relief of many.

Chairman John Wilson stepped down soon after because of ill-health. He died early this year.

Picking up the pieces is new chairman John Monaghan, who as a long-time farmer director on the board concedes he is part of the past as well as the future, and new chief executive Miles Hurrell, a Kiwi and another Fonterra long-server. He's on, we're assured by Monaghan, a much smaller pay package than Spierings was.

The new pairing wasted no time announcing a major strategic review of the $20 billion company's business, direction and assets, along with pledges to sharply reduce debt, be much more transparent and get back to basics.

Farmer-shareholders and the sharemarket should learn of the first of the review's conclusions this month, with the full picture to be known in September.

Fonterra chairman John Monaghan (left) and chief executive Miles Hurrell. Photo / FIle

The promise of change has been a shot in the arm for many farmer-shareholders, says their advocate, Fonterra Shareholders' Council chairman Duncan Coull.

And respected analyst Arie Dekker, managing director of institutional research at FNZC, says Fonterra appears to be "on the right path".

"In the first instance, simplification of the business is a worthwhile pursuit as Fonterra looks to reduce debt and better align its business with its key areas of focus and capability, the New Zealand milk supply, and its current capital structure," Dekker says.

"We think transparency is an important objective through this with insufficient visibility on the business over the last 10 years serving Fonterra's owners poorly."

More change coming

Monaghan promises a review of Fonterra's capital structure next year to support whatever new strategy is arrived at.

The Government is also having a good look at Fonterra, which still handles 80 per cent of the country's raw milk, as part of its review of the dairy industry legislation DIRA (Dairy Industry Restructuring Act).

But indications are the outcome won't lead to fundamental change for Fonterra. More like tweaks of the market obligations imposed by the 2001 DIRA legislation to rein in Fonterra's domestic market power.

Agriculture Minister Damien O'Connor has made it clear the fundamentals are up to farmer-shareholders, not his Government, to fix.

What's also sharpened the focus on Fonterra's business model is the proposed, imminent sale of the financially ailing Westland dairy cooperative to Chinese company Yili.

Westland's a minnow compared to Fonterra but similar in that it is 100 per cent owned by its farmers.

O'Connor says the dilemma facing Westland shareholders as they face losing their 150-year-old cooperative legacy is "a stark reminder to Fonterra shareholders there are always people circling their company who would be very happy to buy it in part, or in whole".

He says shareholders have to pay more attention and take a greater interest in Fonterra "at every level".

Greg Gent, former Fonterra deputy chairman and chairman of one of Fonterra's biggest shareholders, Dairy Holdings, says without "very strong leadership" and the ability to "self-reflect", Fonterra risks heading the same way as Westland. Dairy Holdings supplies milk to Westland and supports the sale to Yili.

"Remember Westland survived and thrived while it was linked to the mothership – the Dairy Board. From the day it set off on its own it began to squander hard-earned farmer equity that has now taken it to Chinese ownership, says Gent.

Advice aplenty

As Monaghan wryly notes, there's no shortage of advice and opinions from NZ Inc as to what Fonterra needs to do to lift its act.

The most popular theory is Fonterra needs to be broken up into a farmer cooperative to handle milk collection and first stage processing of commodities and ingredients, with a new company spun off for discretionary investment – by farmers and outside investors - to make high-earning, value-added food.

It's a model mooted by Fonterra leadership some years ago when capital was becoming problematic, but was rejected by farmers.

But according to Gaynor, a *Herald* investment columnist, some of Fonterra's biggest farmers are now calling for a radical structure change.

"The big thing I've noticed is that when I wrote about Fonterra first the farmers were very defensive of it. There's been quite a change. They'd like the company split in two."

Economist Peter Fraser. Photo / File

Greg Gent supports a split.

"My view is that investments not directly linked to the original intent of the co-op should sit in a discretionary investment vehicle.

"Dairy farmers have a huge investment in dairy. Investing too far away from the farmgate is not core to what they do. A rational investor would want to spread their risk… If they want to invest in a value-add food company, then it would be better from a risk perspective to invest in another multinational who plays in this space.

"So keep Fonterra simple. Yes, we need to add value to dairy but let that function sit in another entity."

Gaynor: "There's nothing wrong with co-ops in themselves but once they get to the size of a company like Fonterra it's not that easy to make them work.

"Definitely capital is a huge problem because you need capital if you're going out internationally."

Long-term storm clouds

Economist Peter Fraser of Ropere Consulting is an adviser to some of the dairy manufacturers that have been chipping away at Fonterra's domestic market power since DIRA deregulated exporting in 2001. A former Treasury economist, he's also been a senior policy adviser on the dairy industry and Fonterra at the-then Ministry of Agriculture.

He says Fonterra will "bumble on in the short term".

"For now it's got assets it can sell – Tip Top, Soprole (Chile), Sri Lanka, the China farms etc. So I suspect it will sell those and focus on being a base commodity company.

"That will stop any serious thinking happening while they have silver to flog. And a commodity company is not entirely bad. Fonterra is actually good at ingredients…it doesn't have the flair to be like a2 Milk or the smarts to be like Synlait, and no money to do either as farmers pillage the organisation for the milk price."

Investment specialist Brian Gaynor says the writing could be on the wall for Fonterra in 10 to 15 years if its performance doesn't improve now. Photo / Getty Images

But FNZC's Dekker says Fonterra's current "rebasing" will not preclude it from growth.

"... But it needs a solid base in New Zealand as a priority and it needs any future direction to be established with a strong focus on capacity, capability and transparency".

Fraser suspects ingredients manufacture isn't a sure bet for Fonterra in the longer term.

Its milk price manual is a "self-imposed own goal" which by his calculations knocks about $7.5 billion off the company's value, he says.

As a Government policy adviser Fraser unsuccessfully argued for an auction to set the New Zealand price of milk.

Fonterra's milk price manual is the specific methodology it uses to calculate the base milk price, also known as the farmgate milk price - the amount farmers receive for each kilogram of milk solids each dairy season.

It was written because New Zealand exports 95 per cent of all milk production so there is no "market price" set through competition for supply. The milk price manual is monitored annually by the Commerce Commission.

Fonterra recently told the DIRA review it could elect to deviate from the manual when it sets the price "but in reality faces some significant constraints on doing this".

But in 2014, a record year for the milk price, Fonterra would have made a big loss if it had had to pay farmers the price set by its manual calculations. Instead, controversially, the company retained about $1 billion due to be paid to farmers.

Chief executive Miles Hurrell says the manual puts the onus on management to get a return above the milk price.

"…In the last 12 months or 18 months in particular we haven't done that. And so we shouldn't talk about the capital structure as a way to cover off any issues around performance. The milk price manual is very clear in that it shows what we pay for milk and then our job is to get a return above that."

Fraser says with static milk growth and the rise of more nimble and well-funded competitors, Fonterra will be forced to close processing plants that have become stranded assets, and potentially do write-offs on others.

Fonterra chief executive Miles Hurrell. Photo / File

"So it's about managing a decline. The question is therefore speed rather than direction of travel. Westland is a harbinger: if declining milk volumes start to bite and they have sold everything then we hit crunch point. Fonterra goes the Westland, Murray Goulburn, Bonlac (failed cooperatives) route."

The longer-term risk, says Fraser, is the threat of competition from artificial or plant-based milks to all producers of base commodities and ingredients.

"Dairy ingredients will simply be irrelevant when alternatives are cheaper and have only a fraction of the environmental footprint. And to those who say this can't happen, just look at the impact of nylon on wool."

What's up?

Investment specialist Troy Bowker, executive chairman of Caniwi Capital, understands one option Fonterra leaders are implementing now is non-bank funding in the form of property sales and leasebacks or other similar structures.

This provides access to funding that does not require equity raising and won't affect its secured lenders, says Bowker, a former head of asset and structured finance at HSBC in London and New York.

But what's more concerning than Fonterra's debt position at 48 per cent leverage, he says, is its ongoing problem of lack of access to capital.

"They face two significant hurdles being a large cooperative that other businesses don't – they have 10,000 farmers as both suppliers and owners and they need an Act of Parliament to change from a cooperative to a company which would allow them to list.

"I doubt this will ever happen despite the merit in switching from a cooperative to a listed company. Farmers can be notoriously slow to embrace change."

Bowker thinks a far more likely solution is some form of spin-off, for example a partial float or joint venture, of Fonterra's fragmented consumer business which has strong pockets in key merging markets.

This spin-off would be a prime candidate to list with Fonterra continuing to hold an investment stake and perhaps licensing its brands, he says.

"It's not without complexity to separate but it's definitely an option for them. That's the path of least resistance and the solution they should be pushing hard."

Meanwhile, back to basics

Bowker says the best way for Fonterra to address its debt position is "good old-fashioned performance improvements" such as cost cutting, margin increases and better management of product mix and seasonality.

He says there is still "way too much corporate excess" at Fonterra.

Another close observer of Fonterra and the $16 billion dairy industry is Massey University business school senior lecturer Dr James Lockhart.

He says a strong, but not necessarily big, dairy cooperative as a robust market price setter is essential for the New Zealand economy.

Massey University business school senior lecturer Dr James Lockhart. Photo / Supplied

Lockhart believes pressure for change at Fonterra is growing and the temptation will be to split it in some way.

"There will be all sorts of views on that and invariably the unintended consequences will be heavily discounted.

"My concern is that the appetite for change will be greater than the willingness to enhance performance – ie any change is seen better than the status quo. That's got to be a real cause for concern."

Lockhart says decision-makers on the future of Fonterra must "embrace the responsibility and opportunity of an effective, robust cooperative".

Discussing the popular spin-off company scenario, he asks how Fonterra's cooperative owners would retain ownership of it.

"If we go to separate companies and if anyone can demonstrate to me the ownership will be retained by farmers in New Zealand in perpetuity, then I'll run with the model.

"But you can't. I'd take the punt it would be a relatively short time before that added-value company was owned by overseas parties."

Lockhart says in the debate over Fonterra's future, he's even heard suggestions the industry return to the regional cooperatives of the last century.

The industry rationale for Fonterra's creation in 2001 was for increasingly large territorial cooperatives and the single-desk exporter the Dairy Board to join export forces for the benefit of dairy farmers and the economy.

"It's being actively talked about," says Lockhart.

"What have we learned? Nothing. Fonterra's got to perform. At no stage in Fonterra's life has the demand for it to perform ever been greater.

"They have to demonstrate to New Zealand, to their shareholders, to their investors they can perform.

"If they don't, the appetite for change is so overwhelming they will lose it."

Now, a word from shareholders

Fonterra Shareholders' Council chairman Duncan Coull agrees it has taken "too long" to recognise that value-creation, aside from in the ingredients business, "has been a struggle".

"It's been masked for the first seven or eight years of Fonterra's life by the absence of a transparent milk price. Effectively we didn't know what we didn't know…."

Coull, who prefers to think of the council as a cornerstone shareholder of Fonterra than a watchdog, says with Fonterra considering divesting assets, care must be taken to decide if the issue with the asset is strategic or one of execution.


Fonterra Shareholders' Council chairman Duncan Coull. Photo / Supplied

"One of the issues of being a cooperative is being agile enough to move with the market.

"We are a slow-moving beast and that has to change going forward – or it (this) will happen again.

"We are more slow to react because we lack belief in ourselves as a co-op and in each other. That's part of the problem.

"Sometimes our governors are trying to second guess the appetite for some things in the shareholder base as opposed to trying to do the right thing long-term and acting in the best interests of the co-op. To some extent it gets in the way of good governance."

Does he see the Westland cooperative sale as a sign the business model is becoming redundant?

"No, there are too many farmers out there that think similarly to me. We understand the strength of the co-op model and we are keen to continue.

"Fonterra needs to do its bit in terms of ensuring its returns reward those who have invested. But beyond that it'll be up the farmers of New Zealand to determine the future of the dairy industry."

Coull suggests the weak performance of shares in the Fonterra Shareholders' Fund, which gives outside investors access to the company's added value activities through dividend-carrying, non-voting units, indicates there's not a lot of support for a separate investment vehicle.

"I don't hear that. But I do think we need to adapt and evolve.

"One of the issues I see as a farmer is how we as a cooperative fund the next generation into the industry. Those are some of the issues we need to address with our capital structure, not whether we split the co-op in two.

"My personal view on the value-added business is 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.

"How on earth can you grow a value-added business when you starve it of capital?"

Coull says the planned review of capital structure will be an opportunity to broaden the debate within Fonterra to how farmers are paid for their milk and how milk is collected.

"If we are going to have a reset, let's leave no stone unturned. We operate in a competitive environment, so do we need to move to a more fluid payment structure… paying on a more regular basis for milk sold to the co-op, this may lead to quarterly pricing.

"We need to simplify the way we pay for milk."

Fonterra farmers don't get the full price of a season's milk supply until the end of the dairy year, receiving instead advance payments against the season's forecast milk price.

"The other thing we need to address is we have (manufacturing) competition coming to some of the most dairying-intensive areas of New Zealand. I worry we may become the most inefficient collectors of milk in New Zealand if in we are left with milk supply around the peripheral."

Coull says there's a more positive mood in the shareholder base with the culture change ushered in by Monaghan and Hurrell.

"The fact that Fonterra is allowing itself to be a little vulnerable in terms of accepting it's made mistakes and things need to change has been widely favourably viewed.

"But the proof will be in the pudding."