

# Intelact Nutrition 2003 Conference

## History of NZ Dairy Industry

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## Reason for my interest

- No strong ideological bent
- Lack of intellectual honesty
- Weak leadership
- Poor process
- Very poor monitoring (out of view)
- Impact on allocation of resources in

## *Cont'd*

- Some experience and expertise
- Old fashioned sense of public duty
- Would like to see it do well

**Note** – I am only presenting publicly available information

# Outline

- Part 1: Origins
- Part 2: Mega Merger
- Part 3: Change

# Part 1: Origins

- Cultural roots
- Approach to marketing
- Strategy
- Outcomes from first 125 years

# Cultural roots

*"Know the past if you would divine  
the future"*

Confucius

“Primitive....unhygienic....tiring....  
boring. Milking cows was hard...”

David Yerex, *“Empire of the Dairy Farmer”*. For many years, Mr Yerex was the editor of the industry’s publication “The Dairy Exporter”





“Cheek by jowl, almost all poor.....”



Enduring serious hardships, including **anthrax** (which is, of course, topical given recent international terrorist threats)



*Annual Report, Department of Agriculture, 1903*

*Gilruth used this photograph in his 1903 annual report to bring home to farmers the deadly nature of anthrax. This farmer died, probably after inhaling spores.*



“....Early dairy farmers all had the same ambition to achieve a decent life for their families. They all came from much the same class in Britain. All shared the same hatred of the worst features of English class society.”

David Yerex, *“Empire of the Dairy Farmers”*

Like gold prospectors of the era, dairy farmers shared a dream that milk production would deliver independence and prosperity

**Arthur Ward:** "No industry involved in the production of food would ever fail in a hungry world"

Dairy farmers' dreams were best summed up by **William Bowron**, the Government's Chief Dairy Expert, in his report to Parliament in 1894:



“The untold enduring wealth of NZ lies upon the surface.....”



“...and the cow is the first factor in the way of securing it.....”



".....We have only to make the prime article in butter and cheese, then no power on earth can stay the flow of **white gold** in this direction."

William Bowron – 'Chief Dairy Expert' for the Government,  
1894





**WAIKATO TIMES,** 11 OCT 1997

“As Waikato's **white gold** builds to a record flush, milk tankers work around the clock to collect it from over 6000 farmers.....”

**THE PRESS,** 14 OCT 2000

“The great silver trucks glide up and down Ashburton's West Street, and then spread out to the plains of Mid Canterbury to fill their bellies with **white gold**”.

**NZ DAIRY BOARD,** 6 APRIL 2001

“Milksolids are the **white gold** left for export processing.....and the Dairy Board sells it all.....” **Neville Martin**

**THE SOUTHLAND TIMES,** 21 JUN 2001

**White gold** flows on down in Southland dairy sheds

“Dairy farmers developed a suspicion of city and urban interests...were seeking more than a fair share of his hard-won livelihood.” Arthur Ward,  
“A Command of Co-operatives”

These ‘outside’ interests included virtually everyone beyond the farm gate: “processors, quality controllers, wholesalers, distributors, merchants, advertising agents, bureaucrats, retailers, financiers and tax gatherers.” David Yerex

Farmers were particularly suspicious, without good reason, that Tooley St merchants (UK importers) were screwing them.

Dairy farmers would congregate for hours and reinforce each other's prejudices

Gordon McLaughlan, "Illustrated History of NZ Agriculture"



Inglewood farmers were



“Unity among farmers emerged from their shared distrust of outsiders” David Yerex

Chew Chong, Taranaki

“Dairy farmers came to believe - and it was an **article of faith** - that they secured more of the selling price of their produce by the cooperative method”

Arthur Ward, “A Command of Co-operatives”

“After a slow start, the concept of the cooperative dairy company spread **like a faith** – an extension of the small-holder’s desire for as tight a mastery as possible over his destiny”

Gordon McLaughlan, “An Illustrated History of NZ Agriculture”

The industry's culture is driven by a fierce determination among farmers to be 'free men'

It is a strange paradox, then, to find the industry was largely created by the Government.

And for 100 years, whenever problems arose, the industry **always** turned to the Government.

Industry historians like Arthur Ward, Gordon McLaughlan, David Yerex highlight that the culture and values of those pioneering days have been powerful influences in the modern era

# Marketing



The essence of any business is to capture value from customers, managing risks efficiently

# Consumers

What are customers willing to pay ?

Can I get a margin to cover my full costs?

What are my competitors doing?

What if demand drops?

Trade access?

Risk of over-supply ?

Exchange rate?

Best logistics ?

QA?

Best presentation? Post-sales service?

How to hedge risks?

Customers' demands  
provide value signals  
for producers

# Producers

Dairy consumers

“The responsibility of selecting a suitable marketing medium... was laid upon the bodies of farmers, who while mostly good farmers, were in **no position to judge the markets** or marketing organisation.”

Mr Pottinger

Director of State Marketing Dept, then  
NZ Dairy Products Marketing Commission

Dairy producers

Dairy consumers

*1895 – 1921*

Govt Dairy Commissioner

*1900 – 1921*

London Office for  
National Dairy Association

*1914 – 1930s*

Govt Board of Agriculture

*1914-21*

'Imperial Commandeer'

Value signals  
'blunted'

Dairy producers

Dairy consumers

1922 – *(date)*  
Dairy Council

1923 – 62  
Dairy-produce Board of Control  
*[Renamed 'NZ Dairy Board in 1935]*

1934 Royal Commission into  
the Dairy Industry

1935 – 47  
Executive Commission of Agriculture

1936 – 47  
State Marketing Department

Value signals  
'blunted'

Dairy producers

# Dairy consumers

1942 – (date)

Reserve Bank Dairy Stabilisation Account

1942 – (date)

Dairy Industry Cost Adjustment Committee

1947 – 62

Dairy Products Marketing Commission

1950s – (date)

Dairy Industry Price Fixing Authority

1953 – (date)

Milk Powder Council

Value signals  
'blunted'

# Dairy producers

Dairy consumers

*1956 – (date)*  
Dairy Industry Loans Council

*1955*  
Govt Committee of Inquiry  
into the Dairy Industry

*1962 – 2002*  
Dairy Products Control + Marketing Board  
*[Renamed 'NZ Dairy Board']*

Value signals  
'blunted'

Dairy producers

1890 – 1914  
Open Exports

Consumers

Wholesale + retail

'Tooley St' Importers

National Dairy  
Association  
(shipping)

Export contracts  
with individual  
co-ops

Dairy companies

Farmers

Signals of  
customer  
value







1922 – 25  
Open Exports

Consumers

Wholesale + retail

'Tooley St' Importers

National Dairy  
Association Limited

Dairy-produce Board  
of Control

Shipping, administration  
+ politics

Dairy companies

Farmers

Export contracts  
with individual  
Co-ops

Signals of  
customer  
value



1926  
Single Desk

Consumers

Wholesale + retail

'Tooley St' Importers

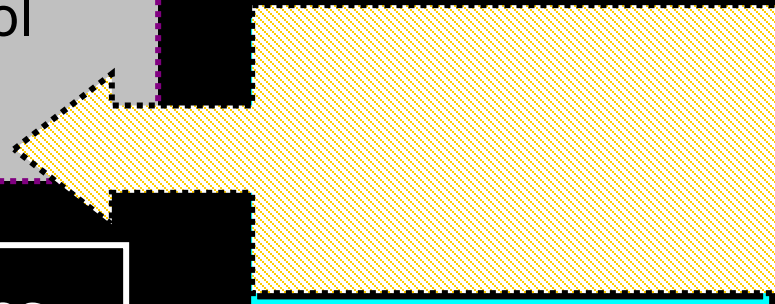
Dairy-produce  
Board of Control

Dairy companies

Farmers

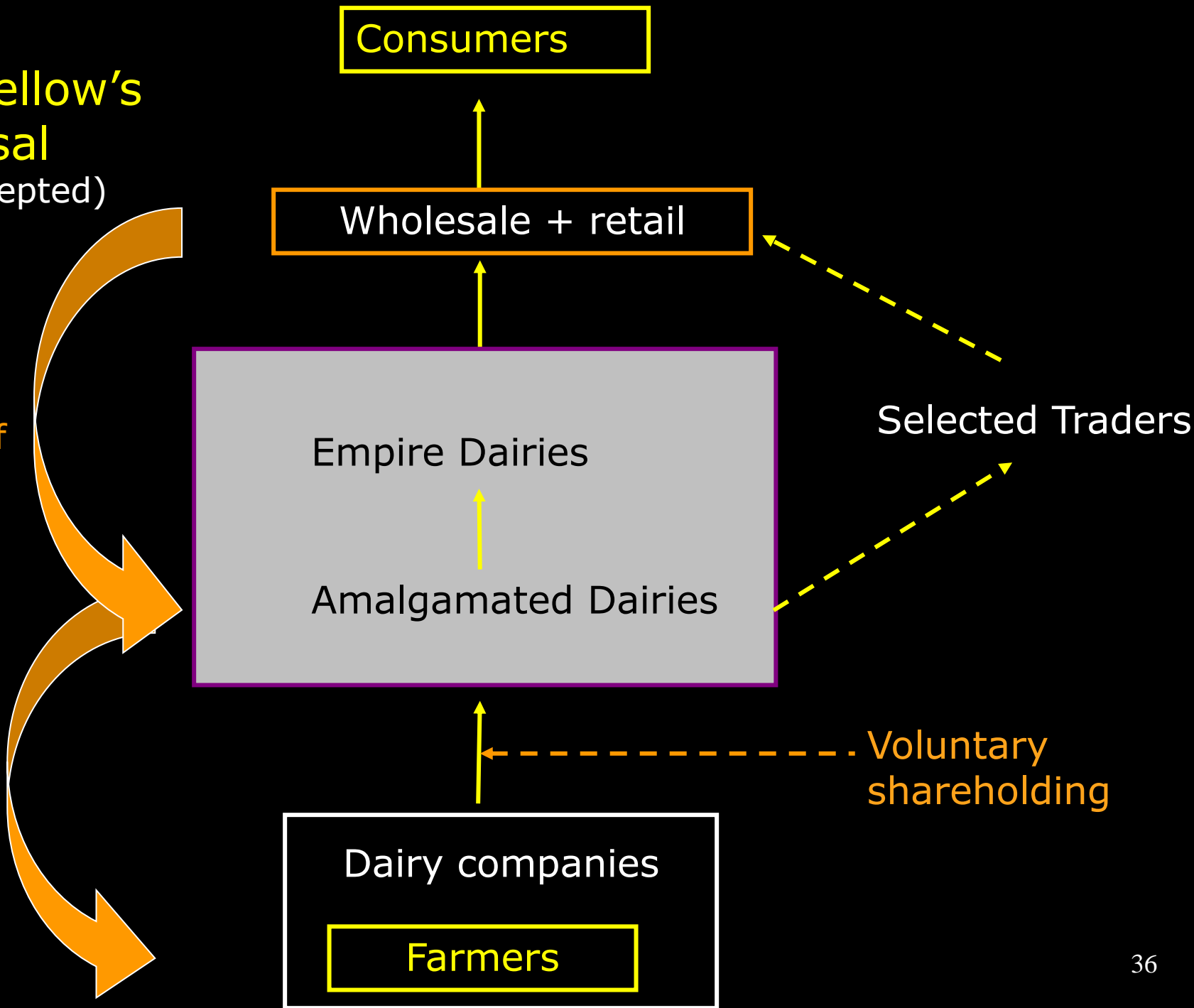
National Dairy  
Association  
(politics)

Signals  
blunted

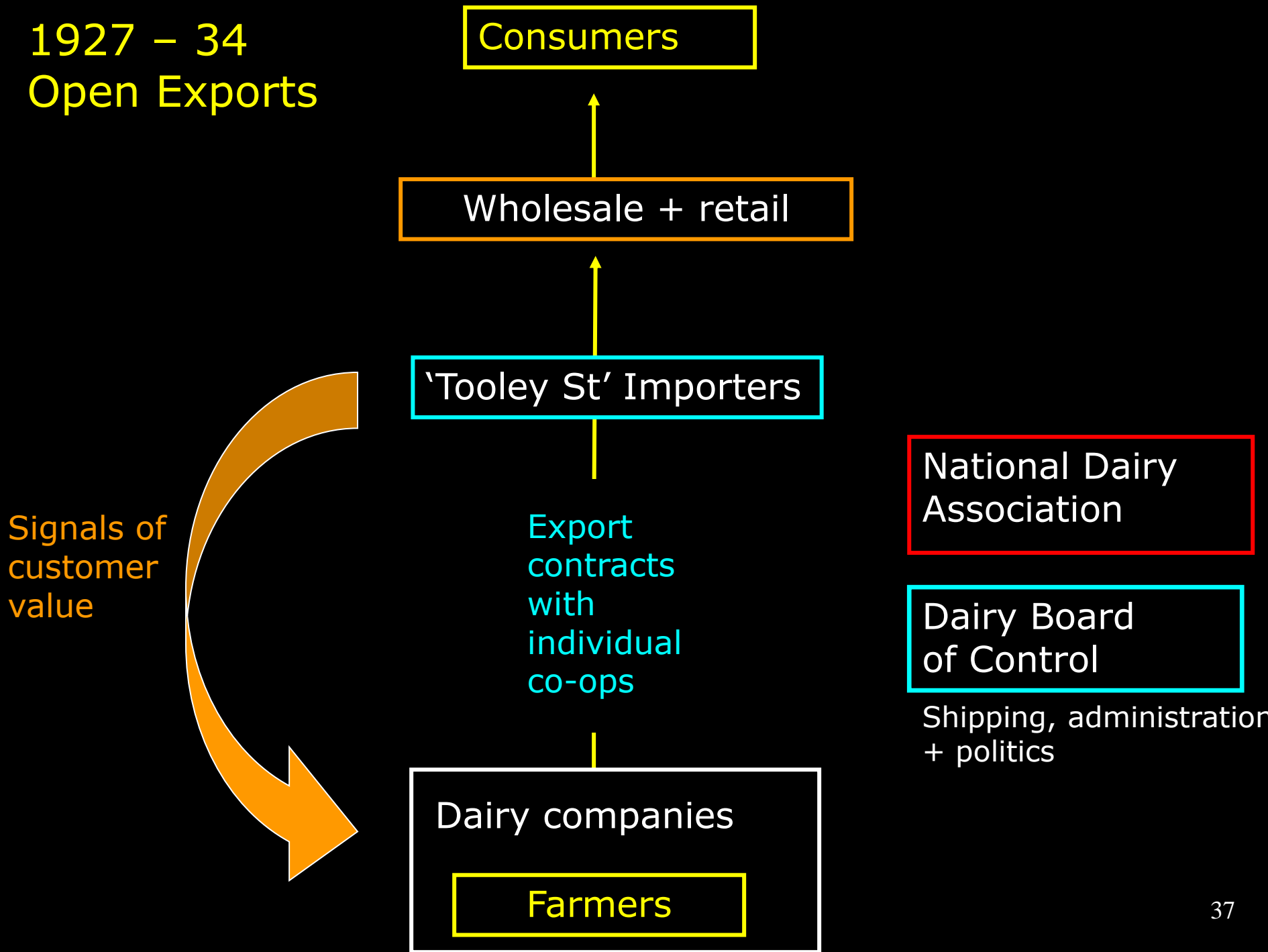


1927  
Goodfellow's  
Proposal  
(not accepted)

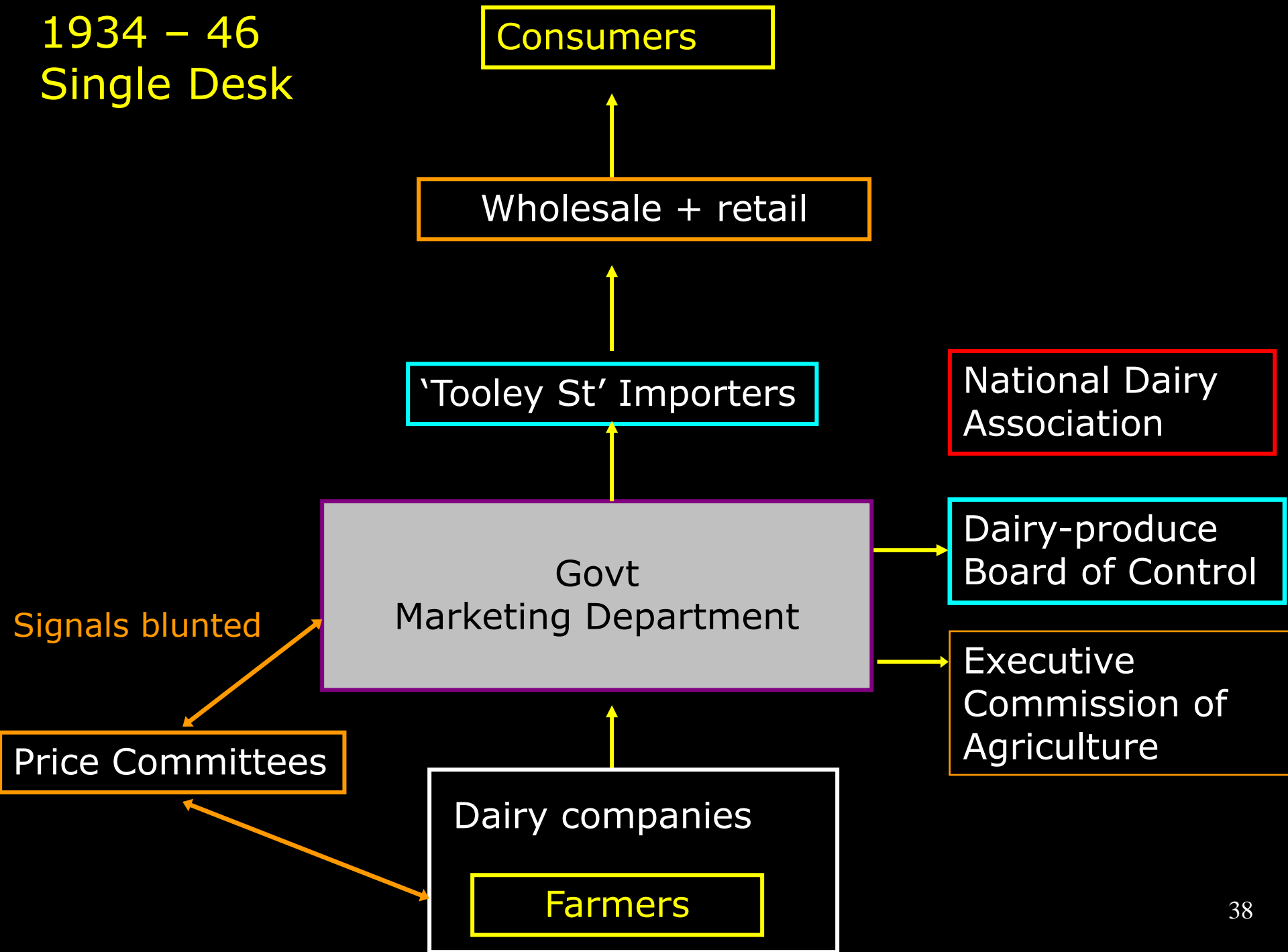
Signals of  
customer  
value



1927 – 34  
Open Exports



1934 – 46  
Single Desk

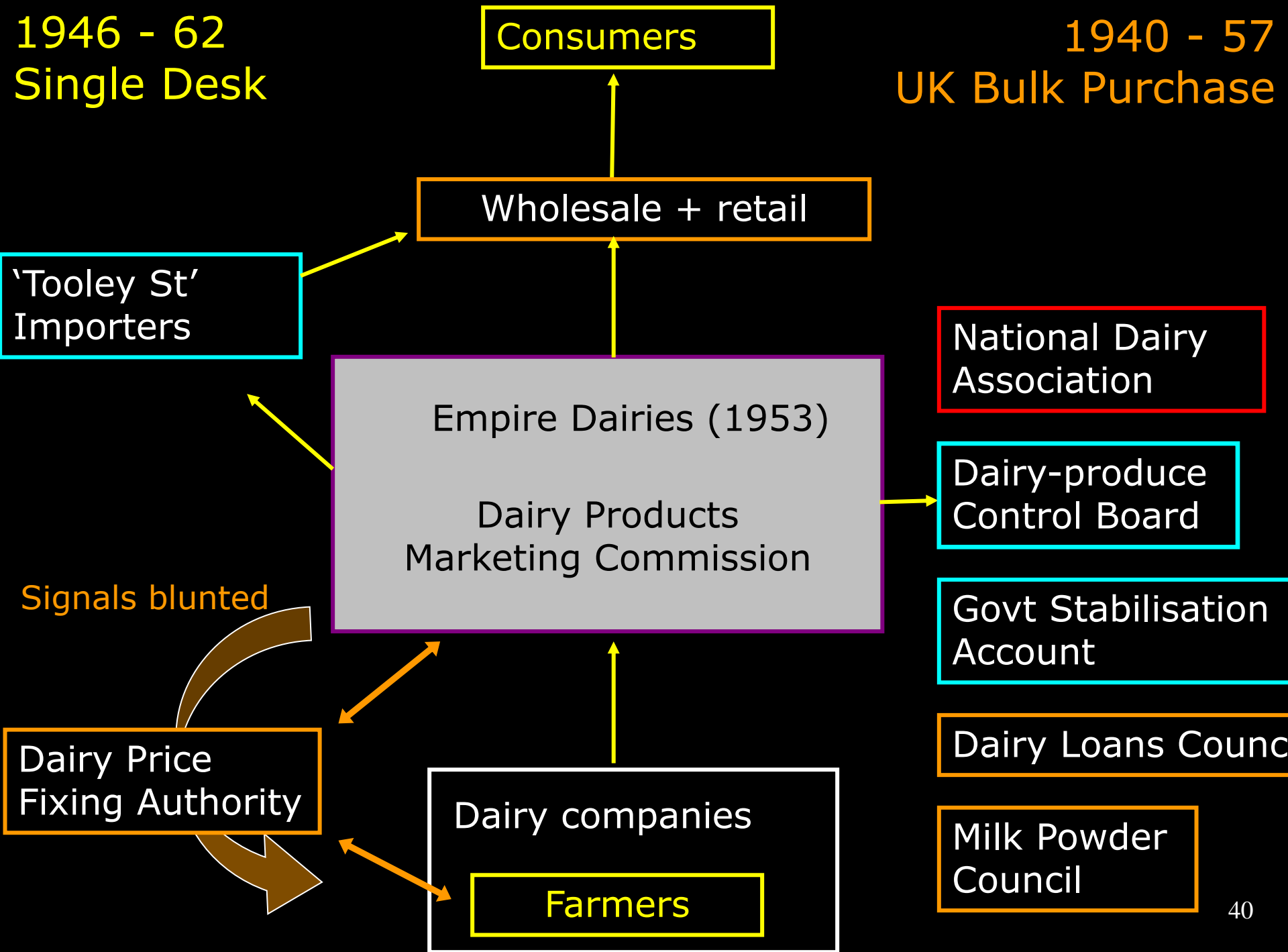


# Government guaranteed price scheme

“Set prices that assure an efficient farmer of a sufficient net return to enable him to maintain himself and his family in a reasonable state of comfort.” From the relevant legislation

1946 - 62  
Single Desk

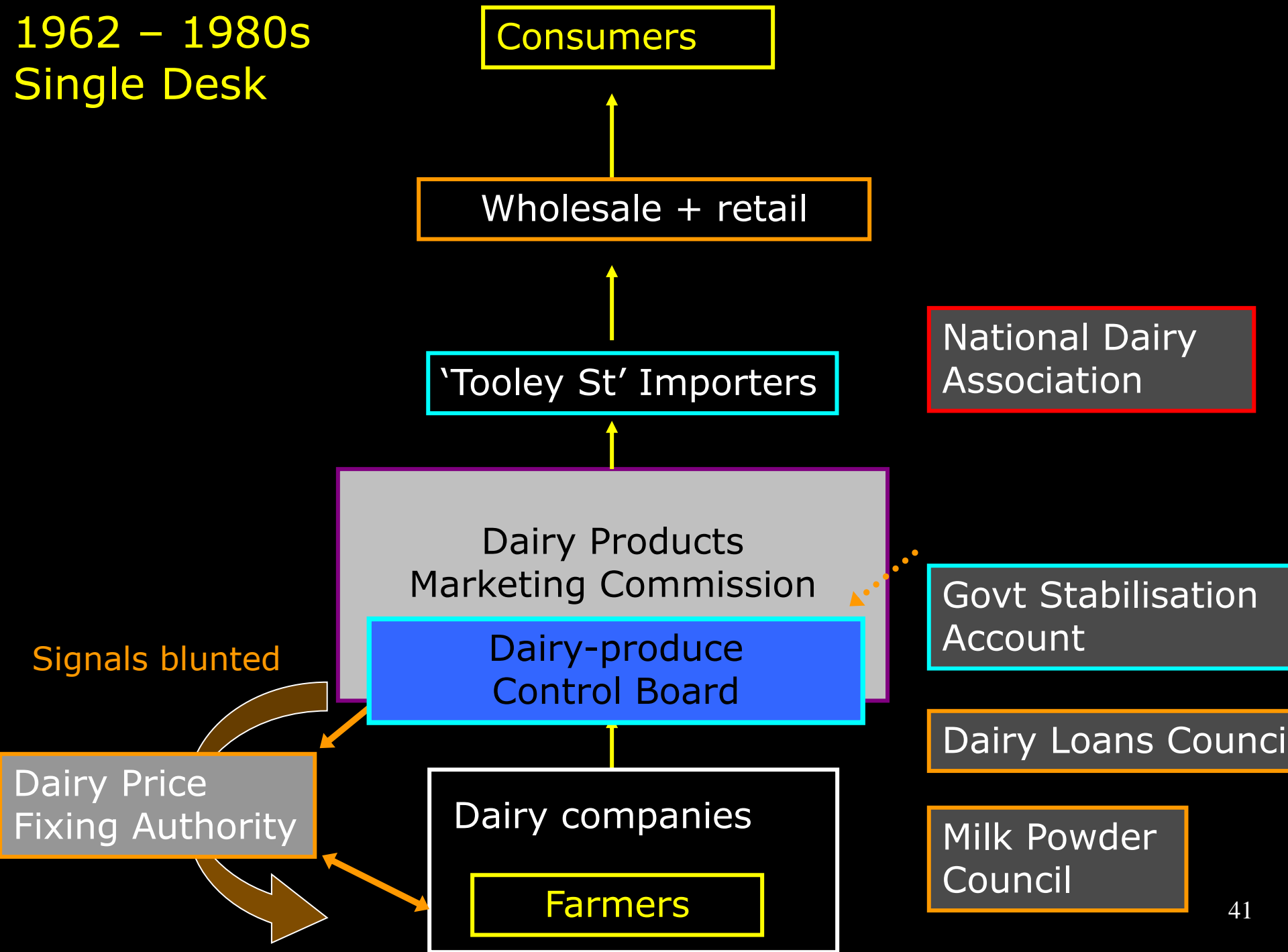
1940 - 57  
UK Bulk Purchase



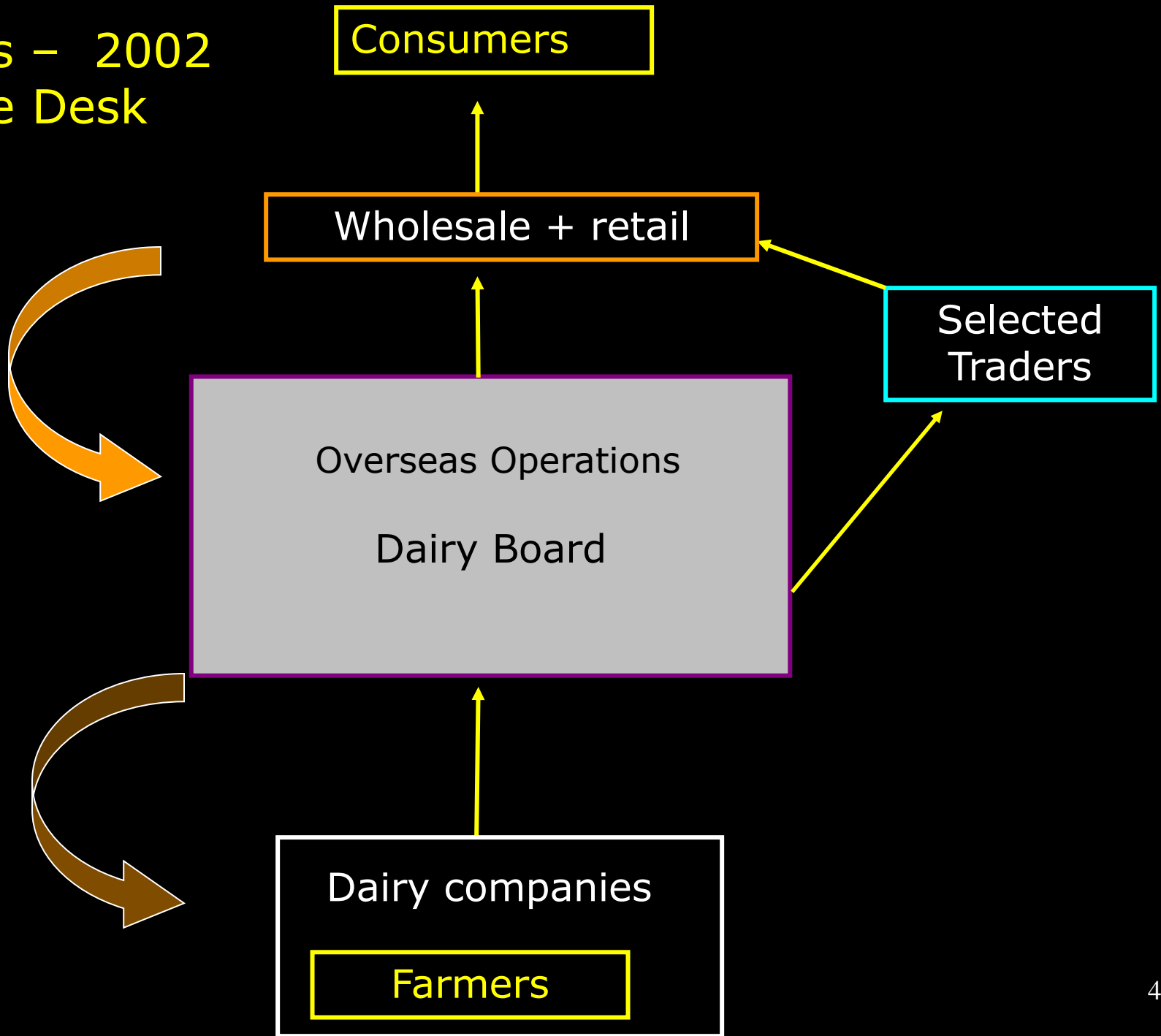
Signals blunted



1962 – 1980s  
Single Desk

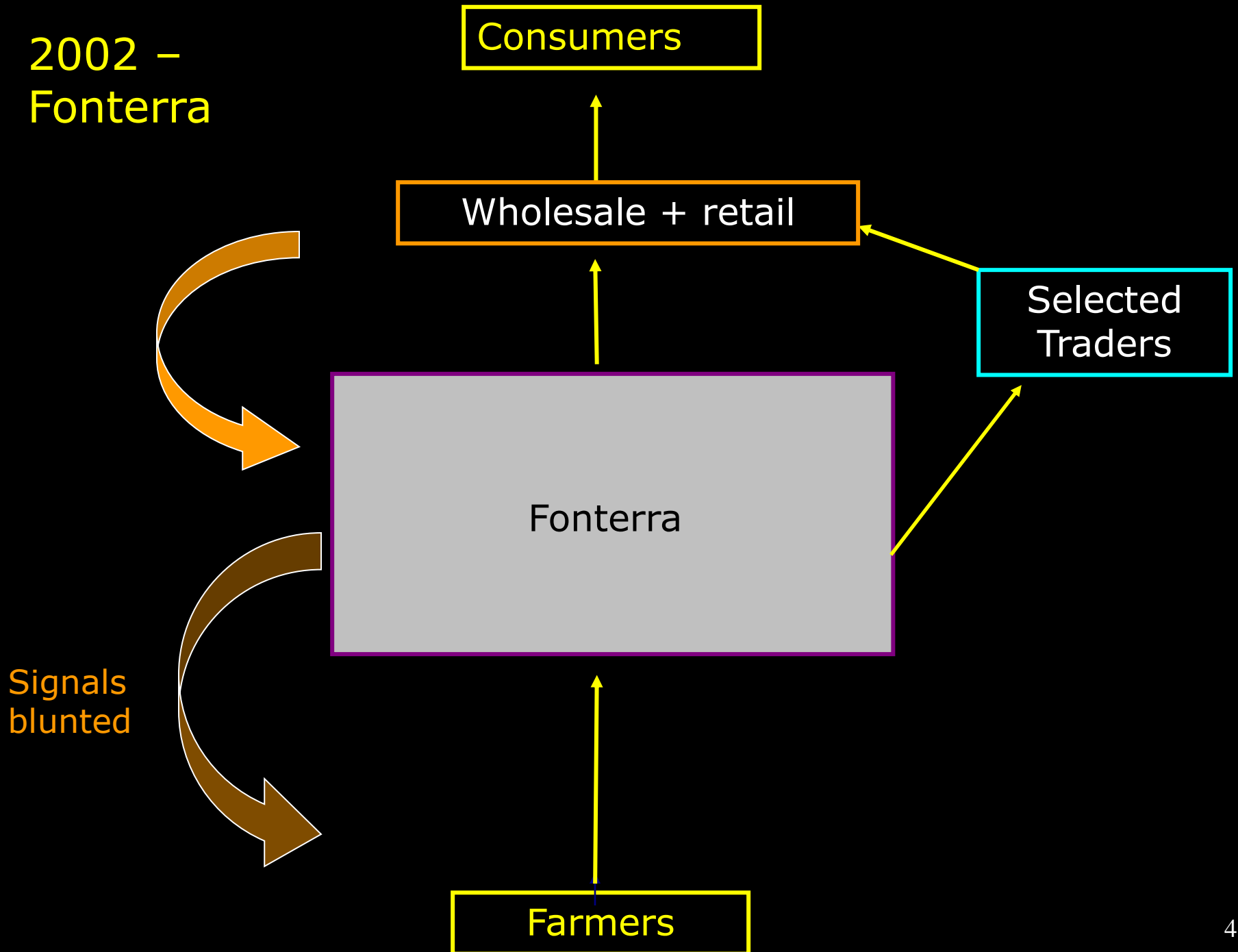


1980s – 2002  
Single Desk



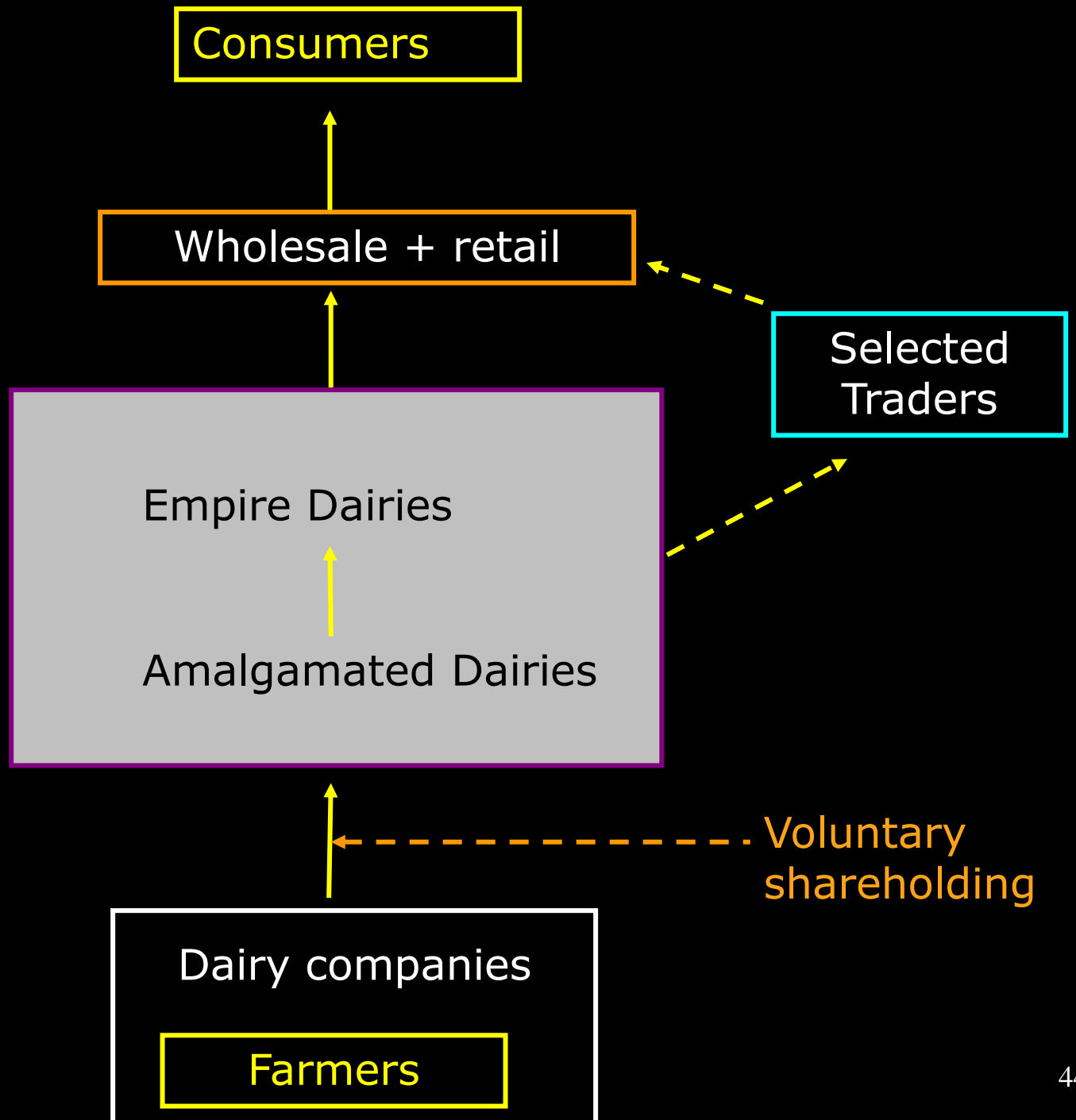
Signals  
Blunted

2002 –  
Fonterra

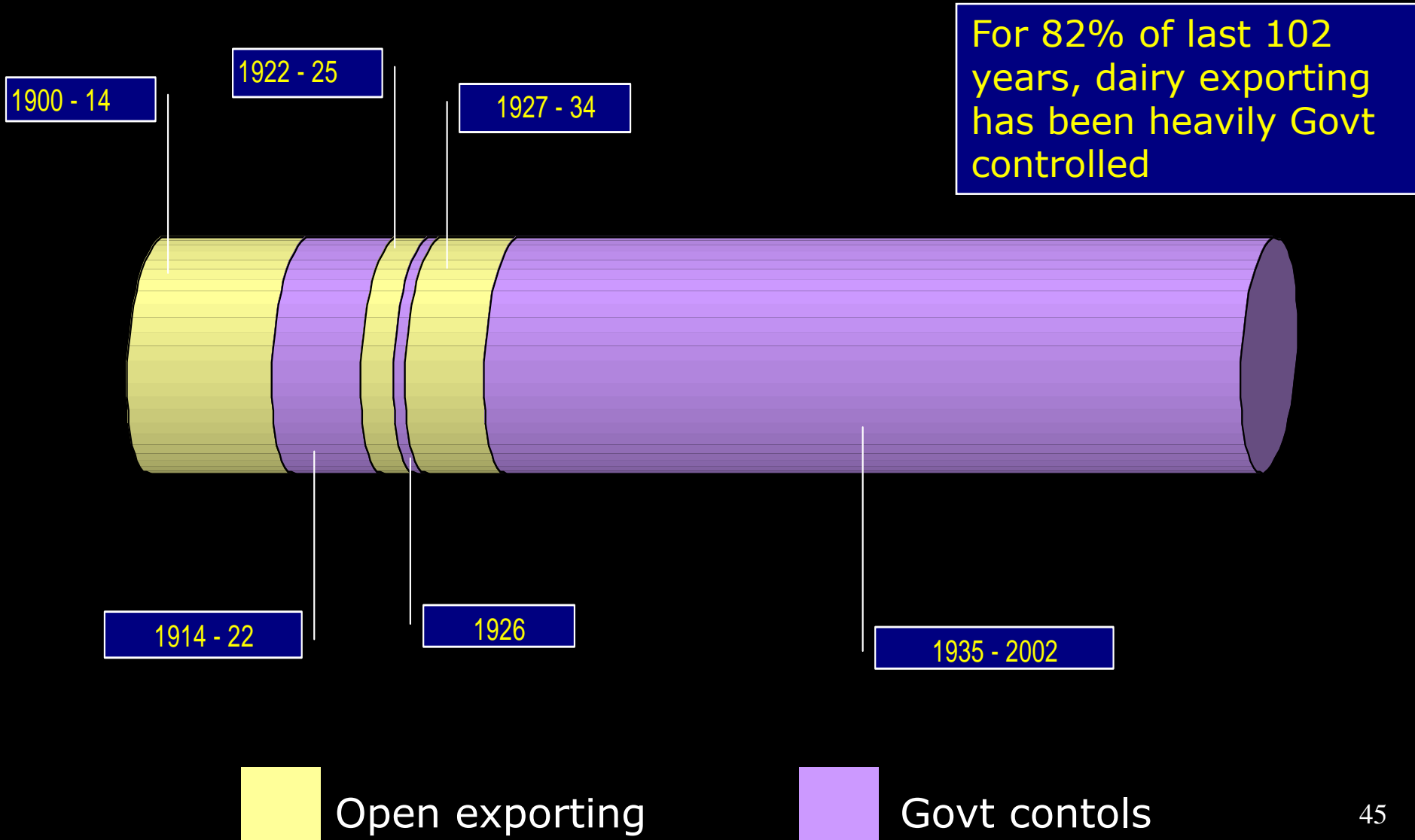


1927  
Goodfellow's  
Proposal  
(not accepted)

Signals of  
customer  
value



# Open v Restricted Exporting



# Industry's strategy

# Strategy

- **Boost production**

This was the principal focus for MAF (dairy division) until quite recently. Other measures included cheap govt loans, opening up Crown land for dairying, govt research funding and institutes, govt dairy advisers and govt prizes for achieving certain export targets

- **Lower costs**

As above, but key factors were govt funded research and development, plus govt instructors and field advisers.

# Strategy (cont'd)

- **Single exporter**

Legislating co-ops, 'single desk' selling, price fixing and smoothing, grading and quality controls and new product development.

- **Minimise internal competition**

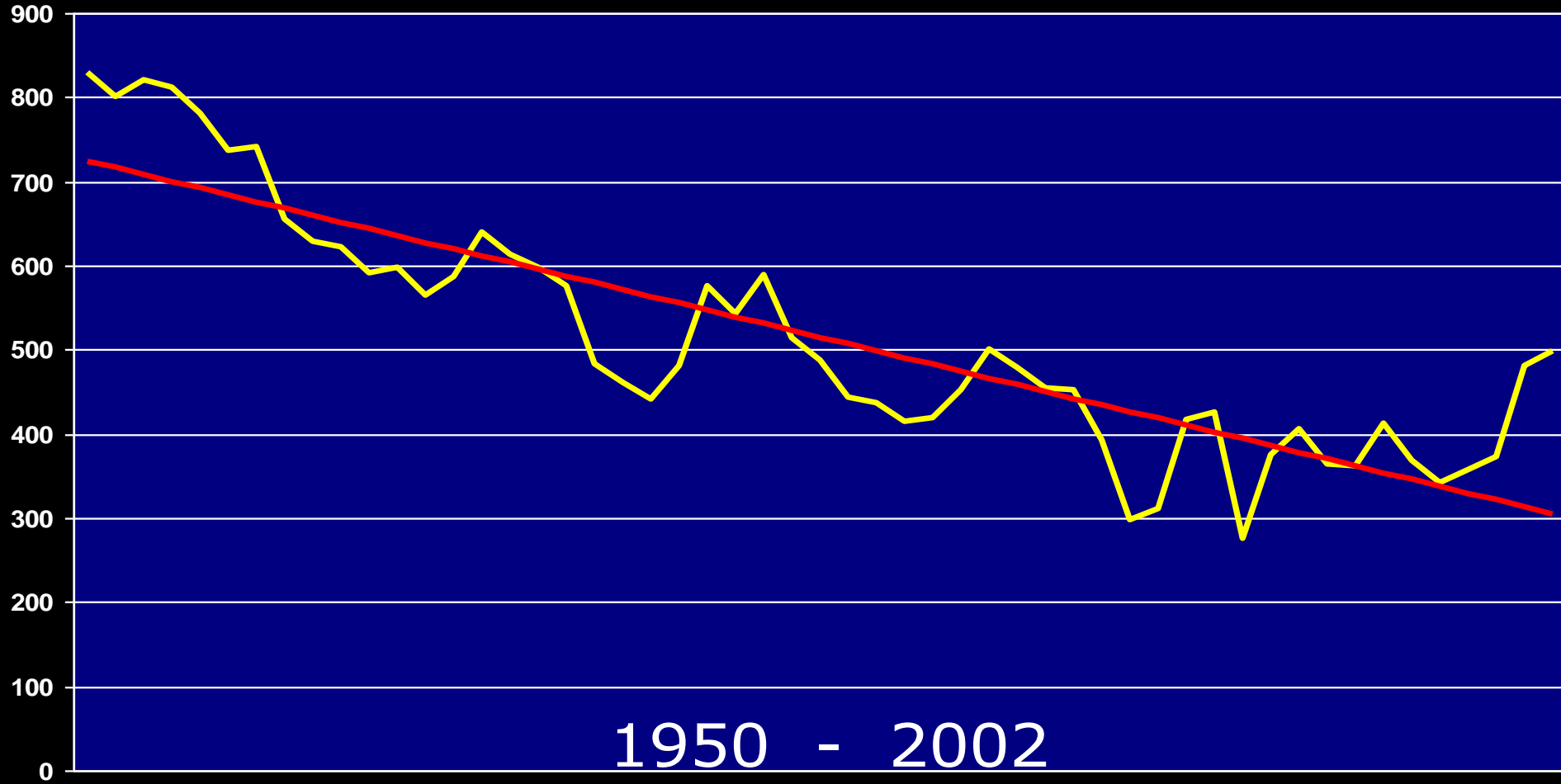
Many examples, including empowering the Board to 'zone' milk collection areas to eliminate 'pernicious' inter-factory competition.



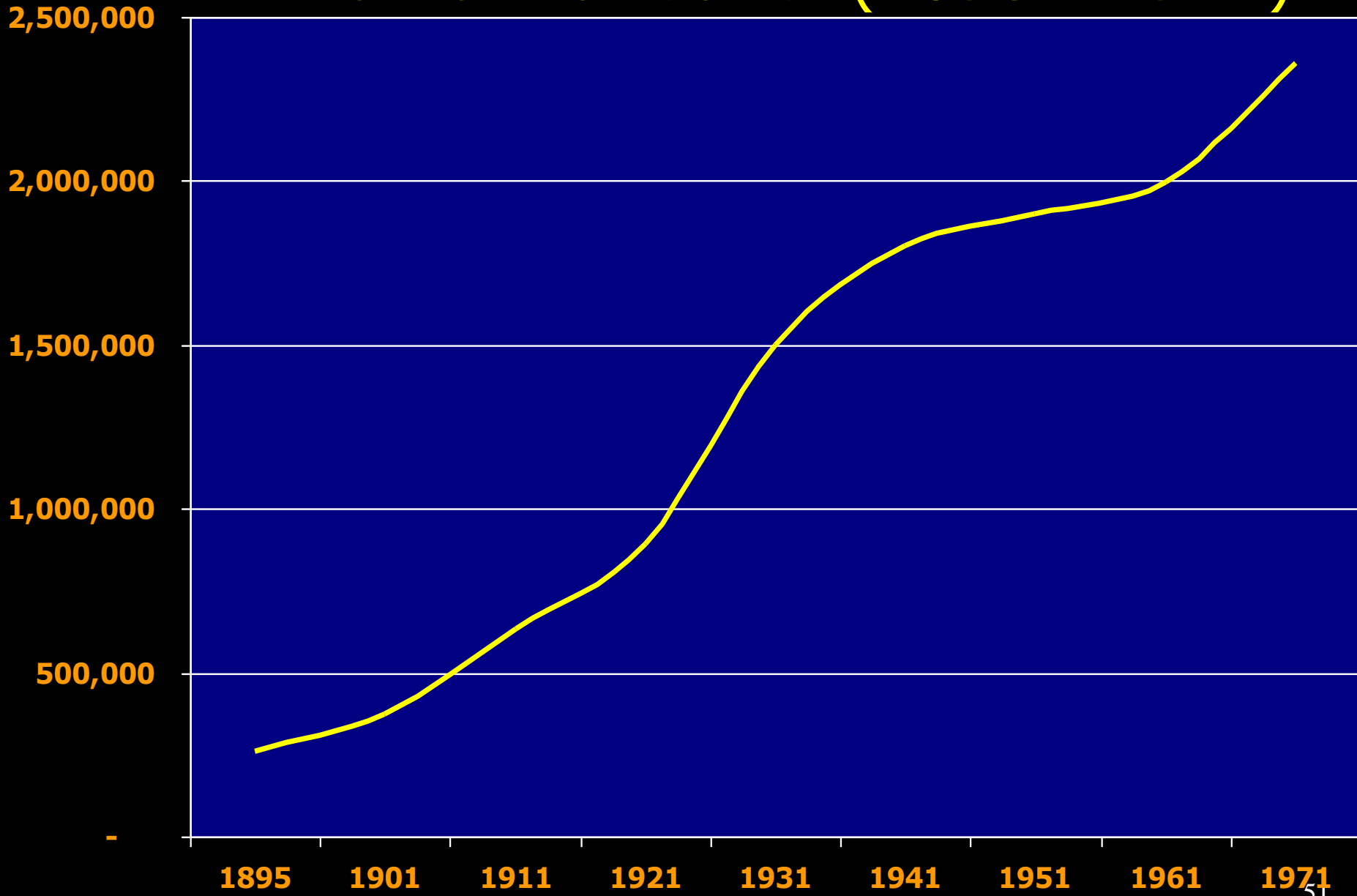
Outcomes

# Real return on milk production

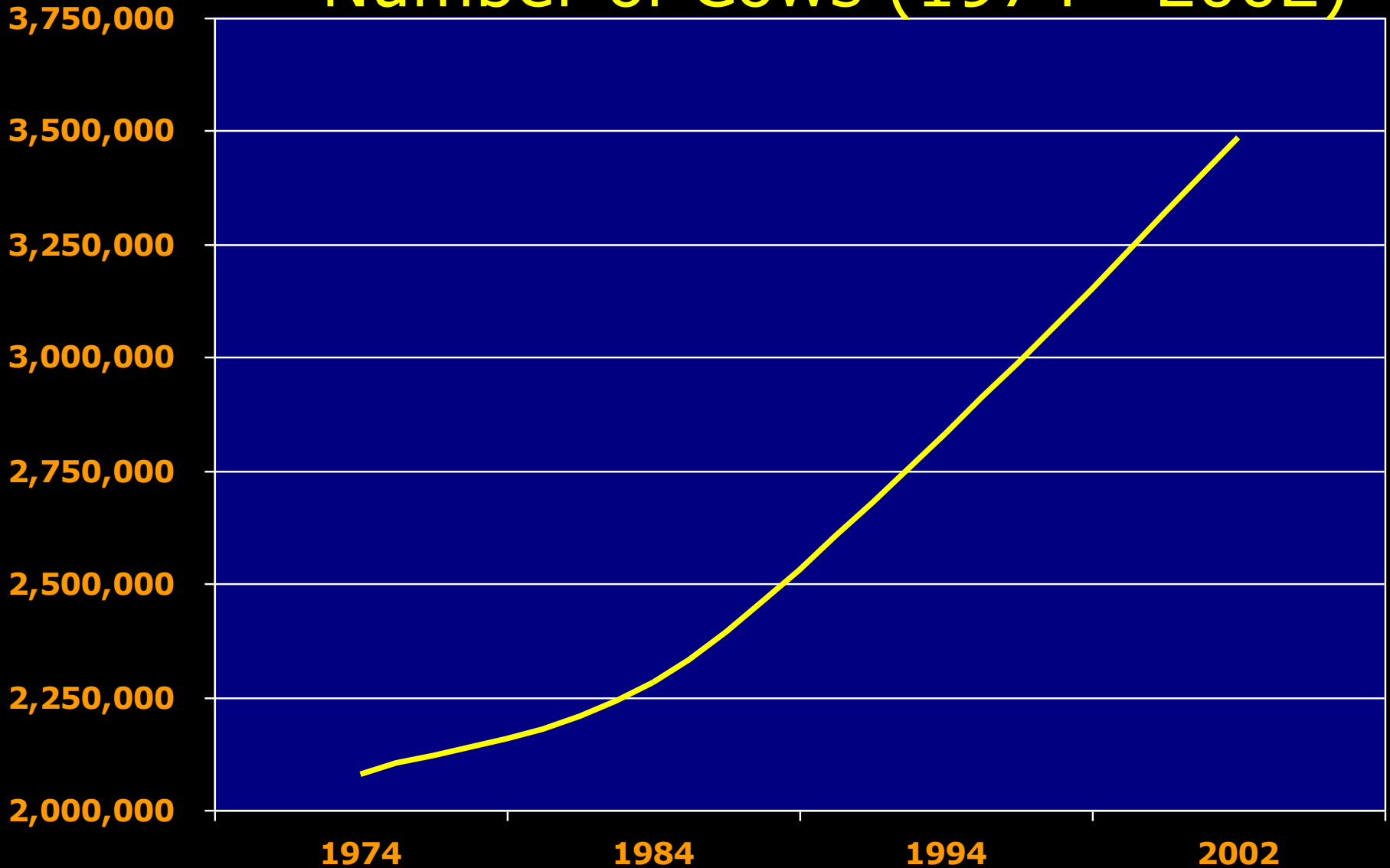
c/kg of milk solids



# Number of Cows (1895 - 1971)

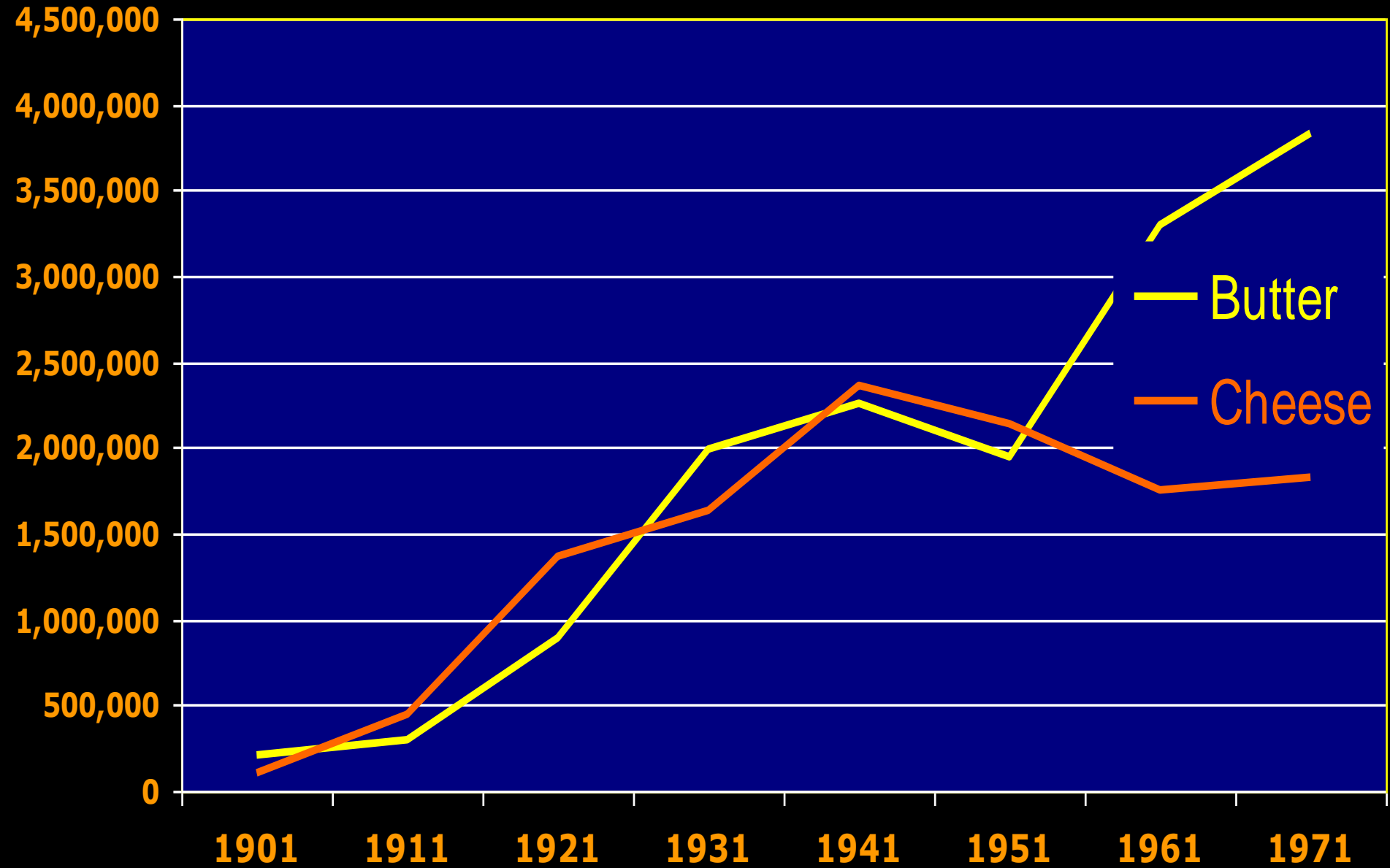


# Number of Cows (1974 - 2002)



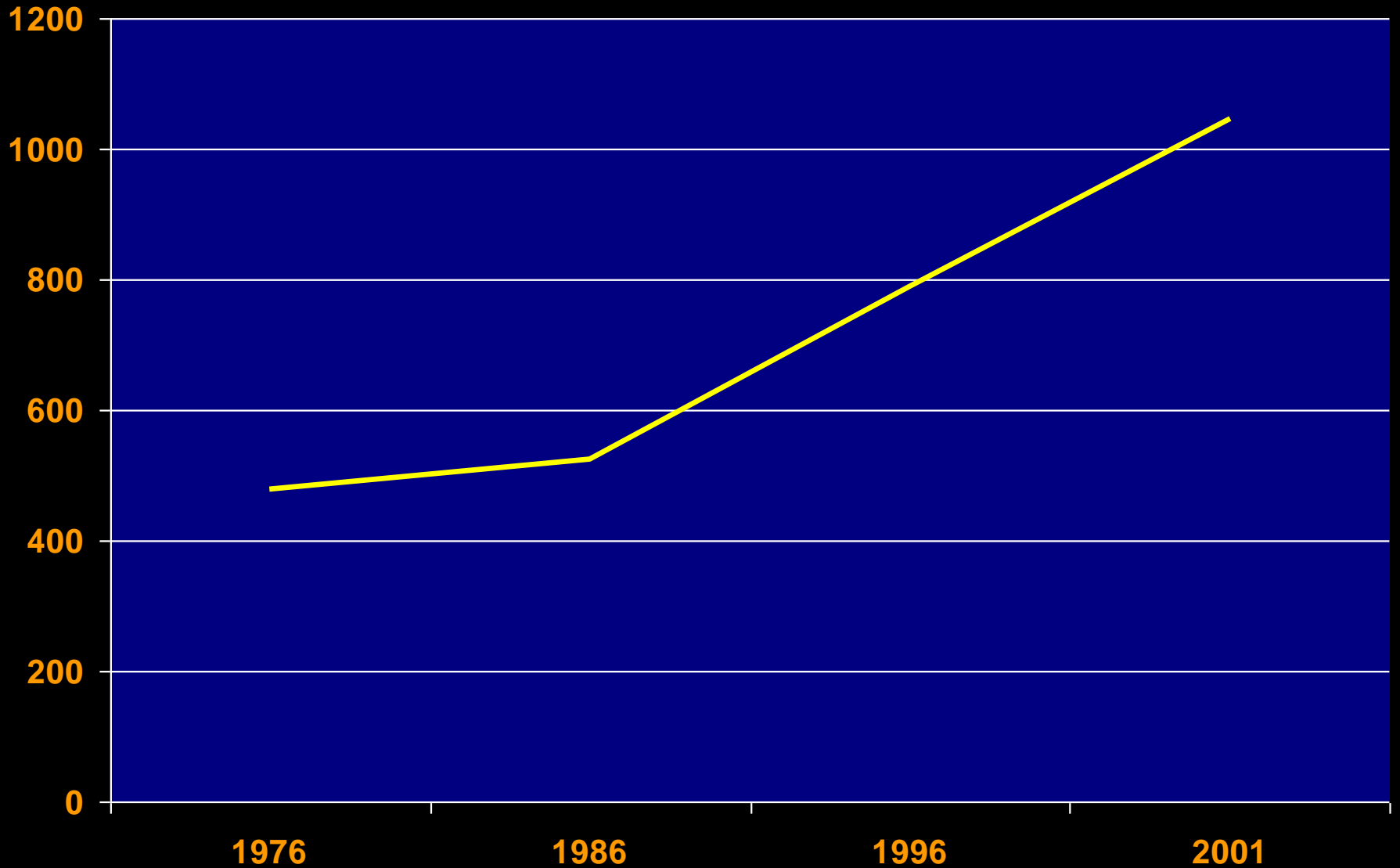
# Production (1901 - 1971)

Hundred weights



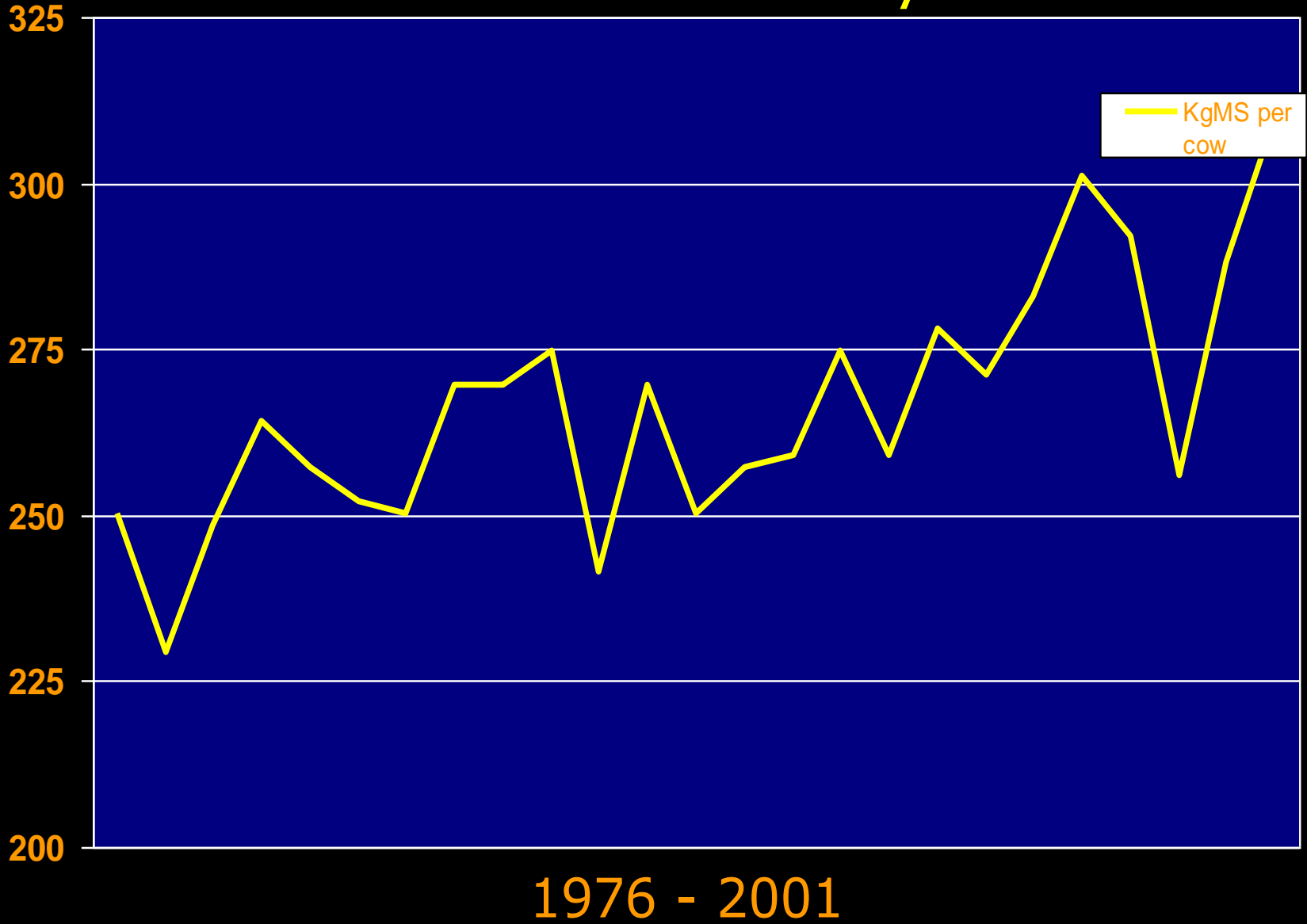
Kg Milk Solids

# Production (1976 - 2001)



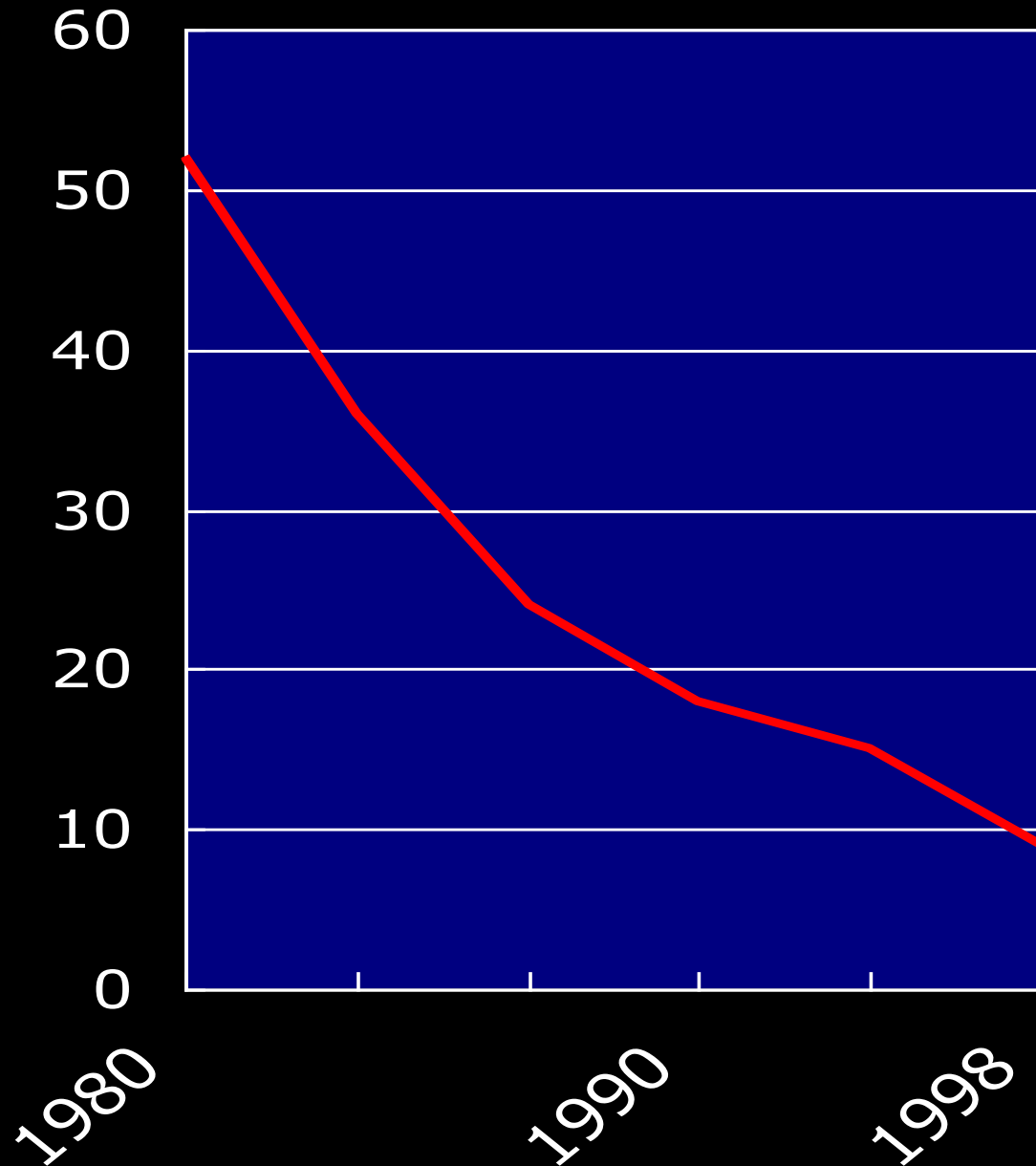
KG Milksolids

# Cow Productivity



# Number of Dairy Cows

Millions





# First 125 years: Positive outcomes

- Strong farming skills + innovation
- Established an important industry
- Grown markets

# First 125 years: Negative outcomes

- **Lost wealth** – poor returns on capital + innovation suppressed
- **Poor skill-base** – under-developed skills in business + marketing
- **Unwise reliance on low production costs** – threatened by genetics + overseas innovation

# 125 year strategy:

## Negative outcomes *(cont'd)*

- **Inflexible assets** – misallocated investment in large, inflexible plant
- **Lack of diversification** – narrow product base
- **Weak governance + political leadership** – leadership is still afraid.

# 125 year strategy: Negative outcomes *(cont'd)*

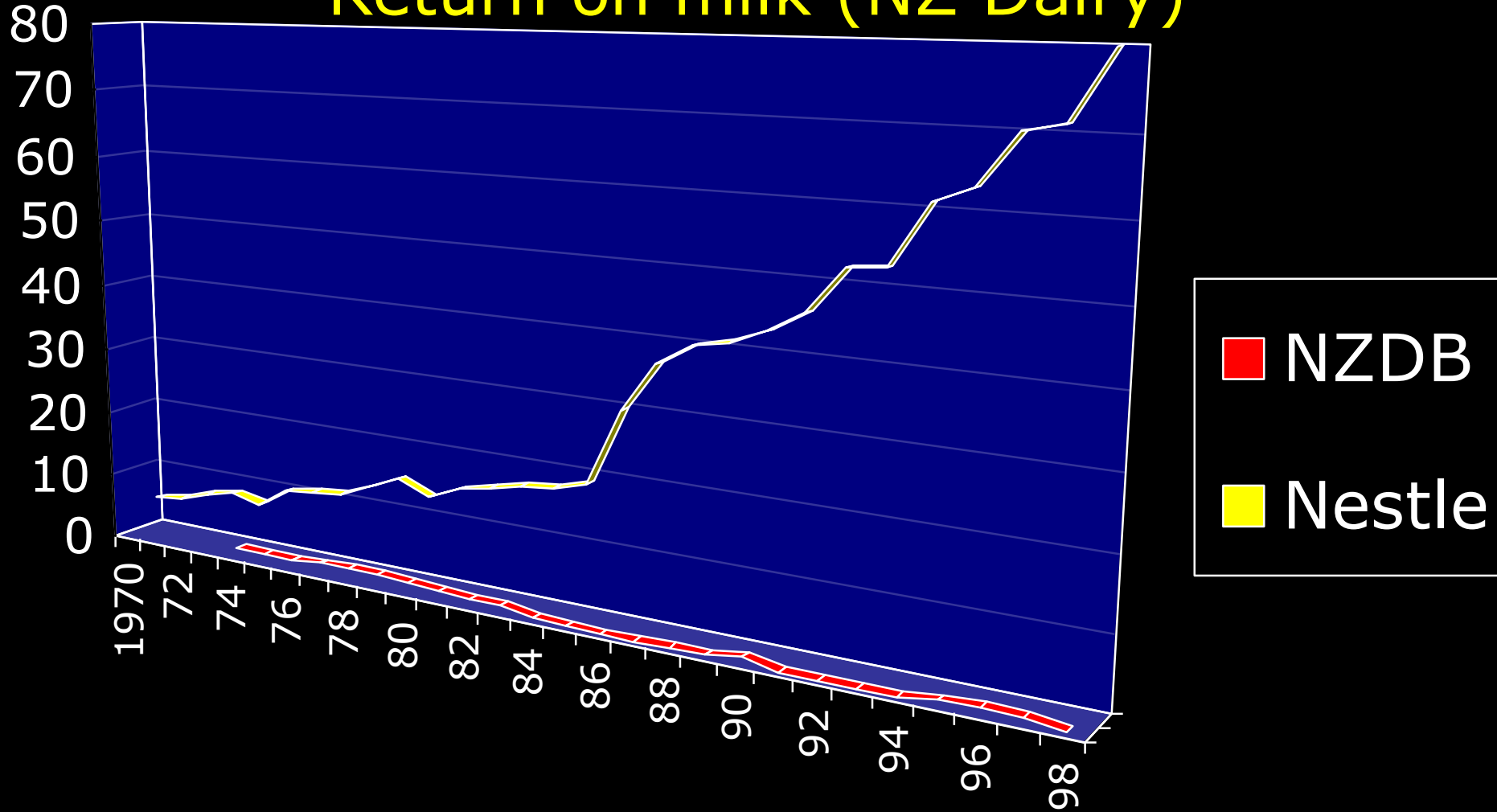
- **Misplaced 'faith' in pure co-operative** – pure producer co-ops do not work well in highly differentiated markets.
- **'White gold' myth** – F's job is to turn milk into cash. Belief that more profit comes from more milk. Not necessarily so
- **Rights to wealth** – Those who produce raw milk are entitled to the lion's share of wealth created from milk. Not so.

# 125 year strategy:

## Negative outcomes *(cont'd)*

- **Who the exporter serves** – Farmers expect F to serve them as producers. Should serve customers.
- **Fixation with 'control'** – Farmers are not in 'control'. Blind to more efficient ways of gaining 'control'.
- **Don't trust 'outsiders'** – “Farmers are unnecessarily suspicious of approaches from business interests” *Arthur Ward*

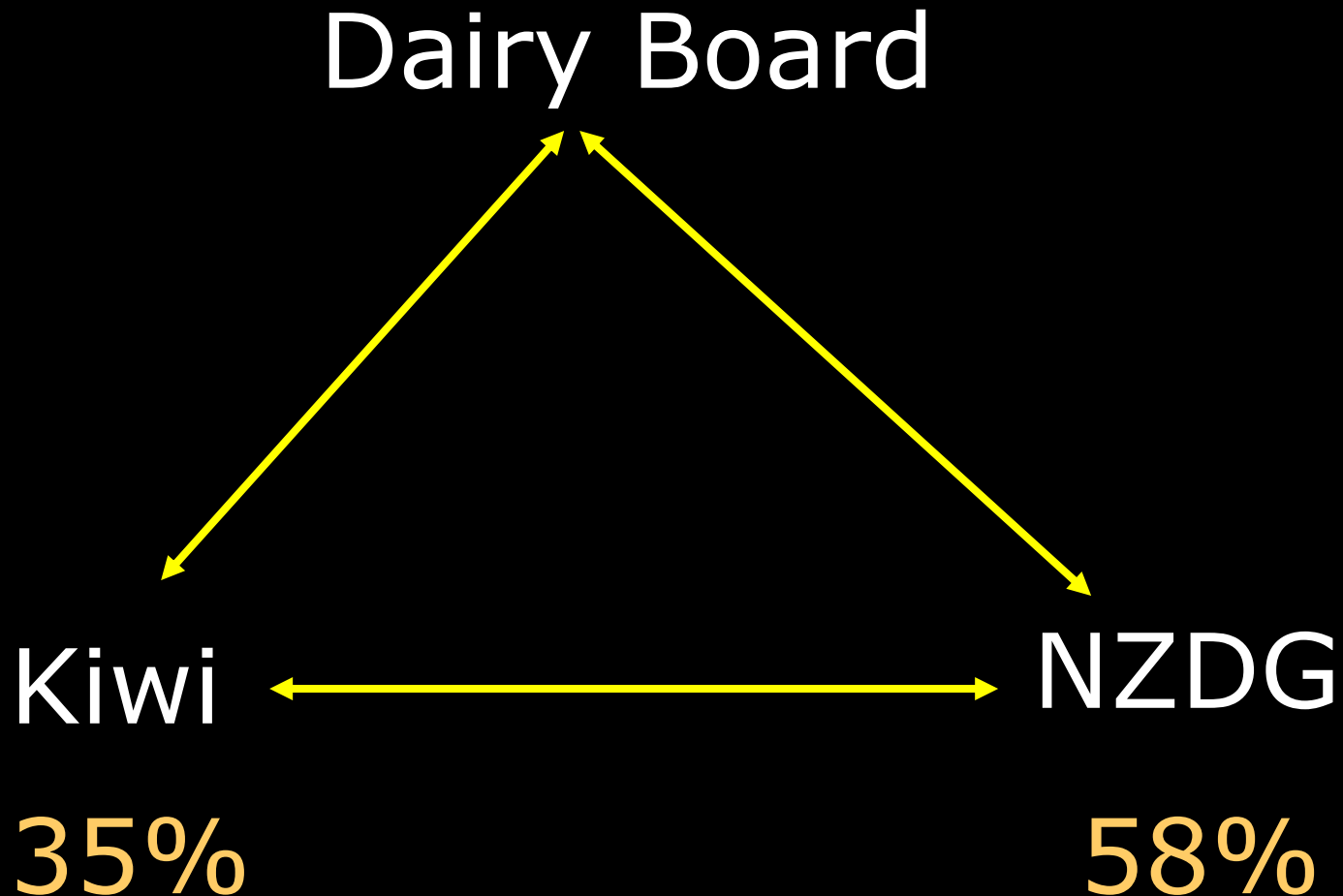
# Earnings per share (Nestle) v Return on milk (NZ Dairy)



# Part 2: Mega-merger

- Race for Control
- McKinseys vs Commerce Commission
- Comparison of 1999 + 2001
- 2001 Negotiations
- 2001 Decision

# 1990–2000: Race for control





# Kiwi v NZDG v Dairy Board

- Conflict of philosophies:  
Co-operative v corporate  
Single exporter v competing companies
- Conflict of egos:  
Spring v Storey  
Larsen v Norgate  
Van der Heyden v Gent

# Real economic problems

- Inefficiency:

Weak pricing

Inefficient production

Inefficient investment

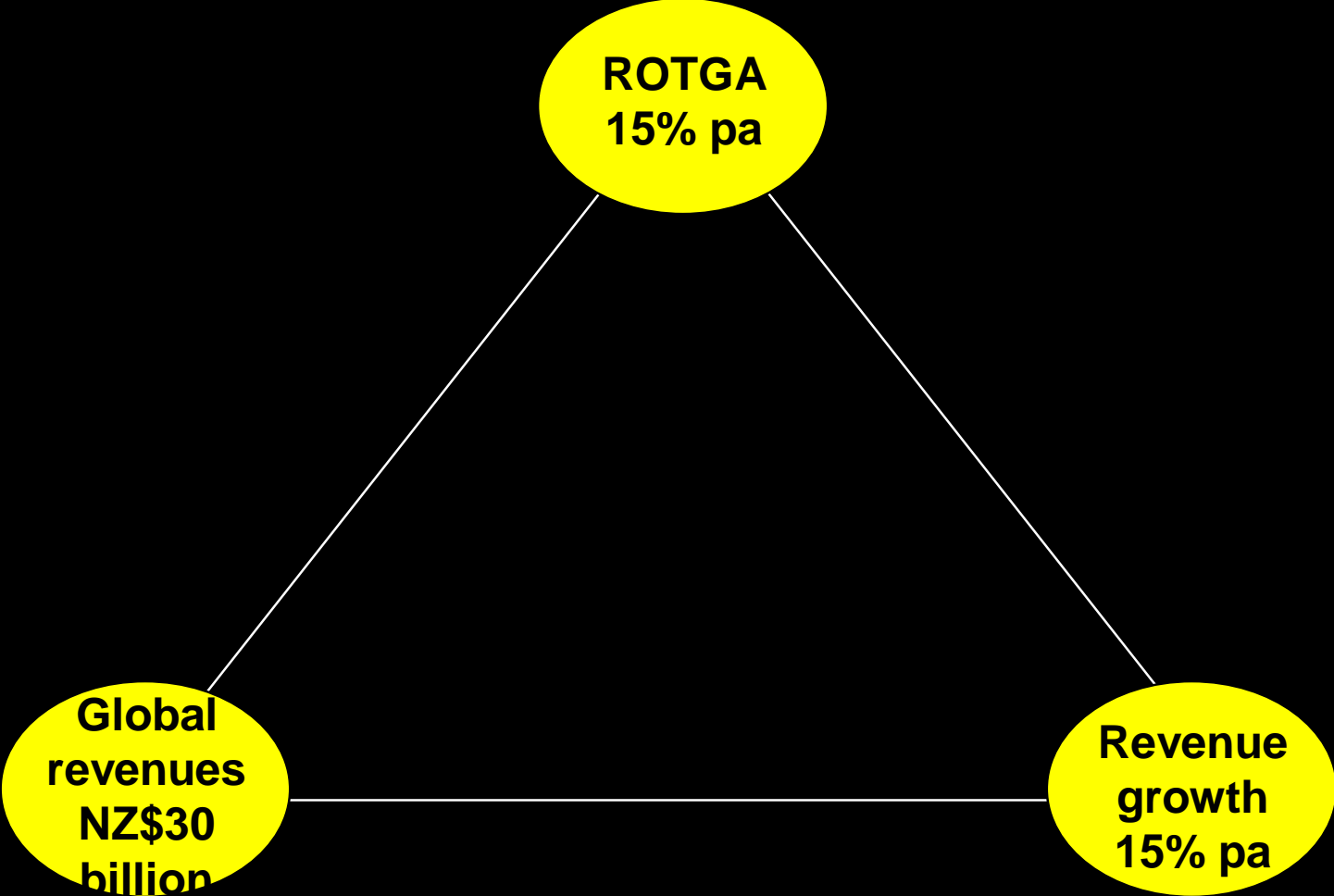
- Poor Governance:

Management control of Dairy Board + Kiwi

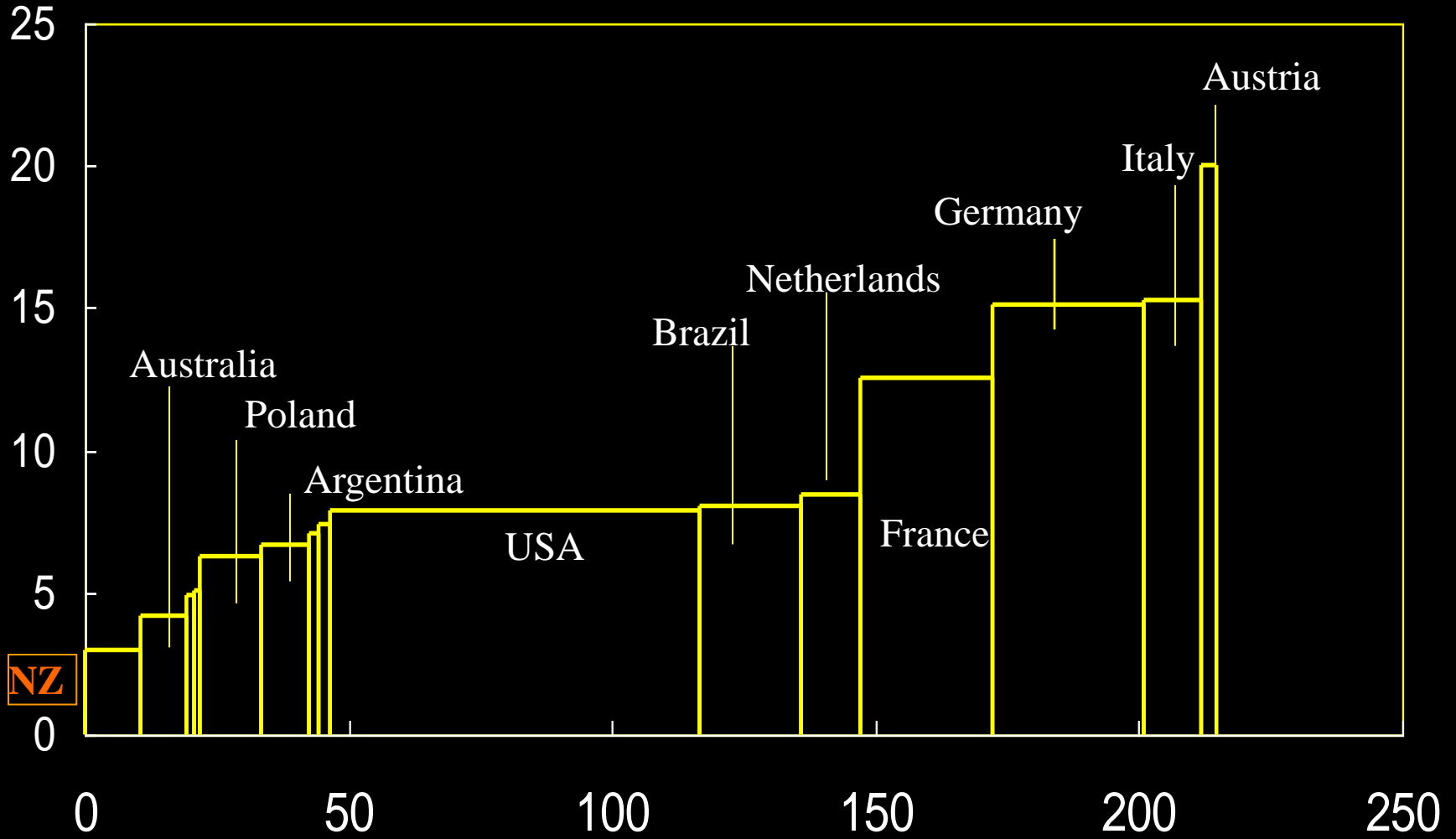
Cap on director numbers at Dairy Board  
(5/13)

McKinsey advice

# 10 Year Financial Aspiration



# Global Dairy Industry Curve



**Milk Cost**

\$NZ/kg Milk Solids

**Milk Production**

Million Tonnes

If the US industry were to double its rate of unit cost improvements through biotech while we do nothing, it will have destroyed \$5bn of value for NZDI after 5 years

*McKinseys*

**NZ unit cash costs  
rising at 2.3% pa**

**US unit cash costs  
falling 1.8% pa**

# Growth Horizons

Profit

## Horizon 1

Extend and defend core businesses

- Defend and exploit core low cost position
- Earn the right to grow

## Horizon 2

Build emerging businesses

- Industry Milks strategy
- 'Global slivers' in specialised ingredients
- Leverage our ingredients network beyond NZ Dairy

Horizon 3  
Create viable options

- Industry biotechnology agenda
- Risk management services

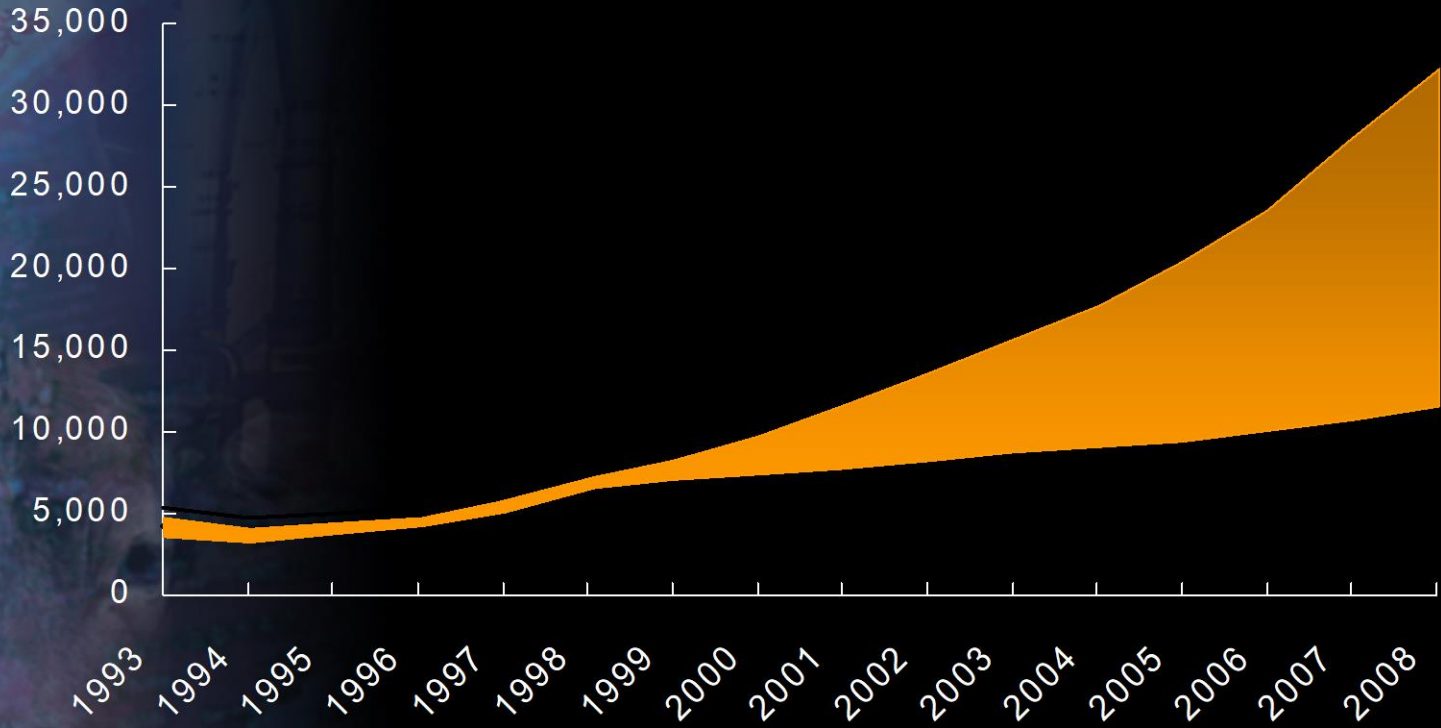
Time

# REVENUE GROWTH

\$ Millions

990511NZNZD005JKCP1

Horizon  
2 and 3



\$19 billion  
Horizon 2 and 3  
'Non-core'  
growth

\$11 billion from  
Horizon 1  
'Core business'



Build our niche positions into global 'slivers' by . . .


**Focusing on the most attractive products . . .**

- Alamin
  - Protein hydrolysates
  - Colostrum products
  - Functional minor components
- . . . that don't cannibalise our existing sales and have consumer noticeable functionality

**Leveraging existing capabilities . . .**

- Clearer focus and investment in new product development
- Sharper customer insight
- Access to non-NZ milk
- Use other Dairy companies as residuals

# SPECIALISED INGREDIENTS FOCUS FOR FUTURE INVESTMENT

 Intersection of capability and opportunity

	Consumer noticeable			Not consumer noticeable		
	Nutritional	Flavour	Clarity	Yield	Film	Emulsificatio
Casein	TMP, Casein phospho-peptide		High clarity acid casein	MPC, Alapro 4850	Acid casein	Calcium caseinates
Whey	Alamin, WGC, WPI, Hydrolysate	Alacen 845	WPI	Surimi plus		
SMP		Caramelised milk powders				
BMP						
Cheese		Cheese Pastes		Egmont cheese		

# FINANCIAL CAPACITY

\$NZ billions

Total Capital required

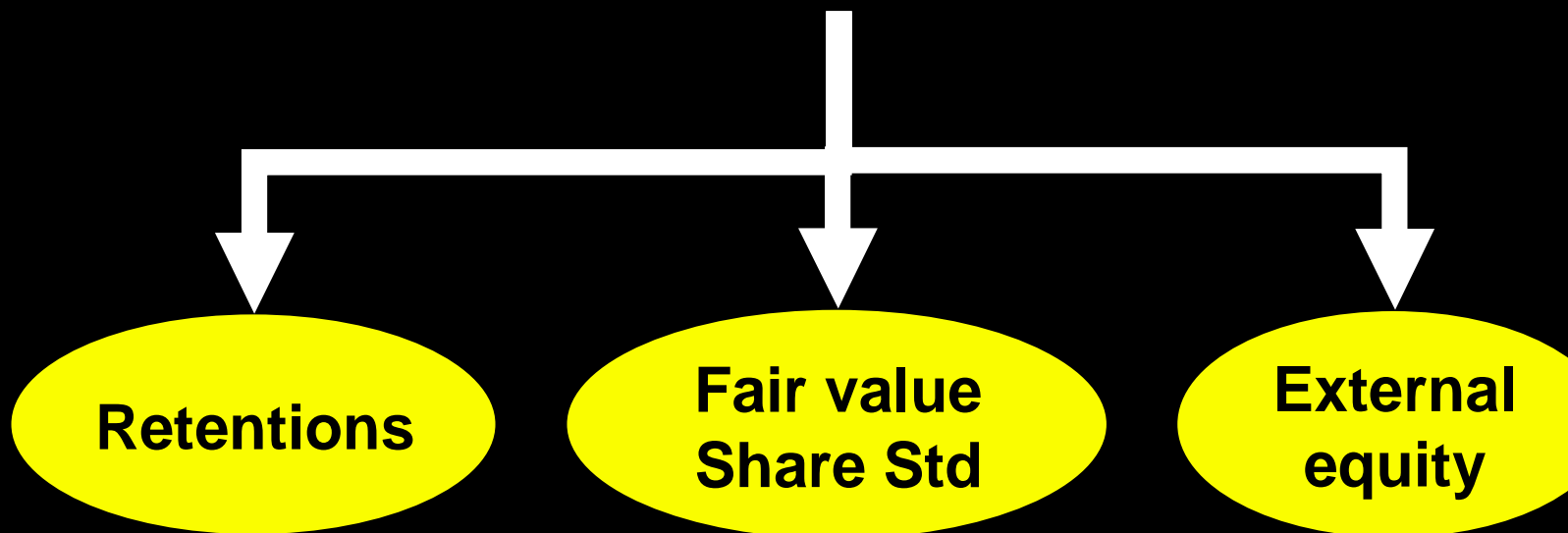
12

Less Debt capacity

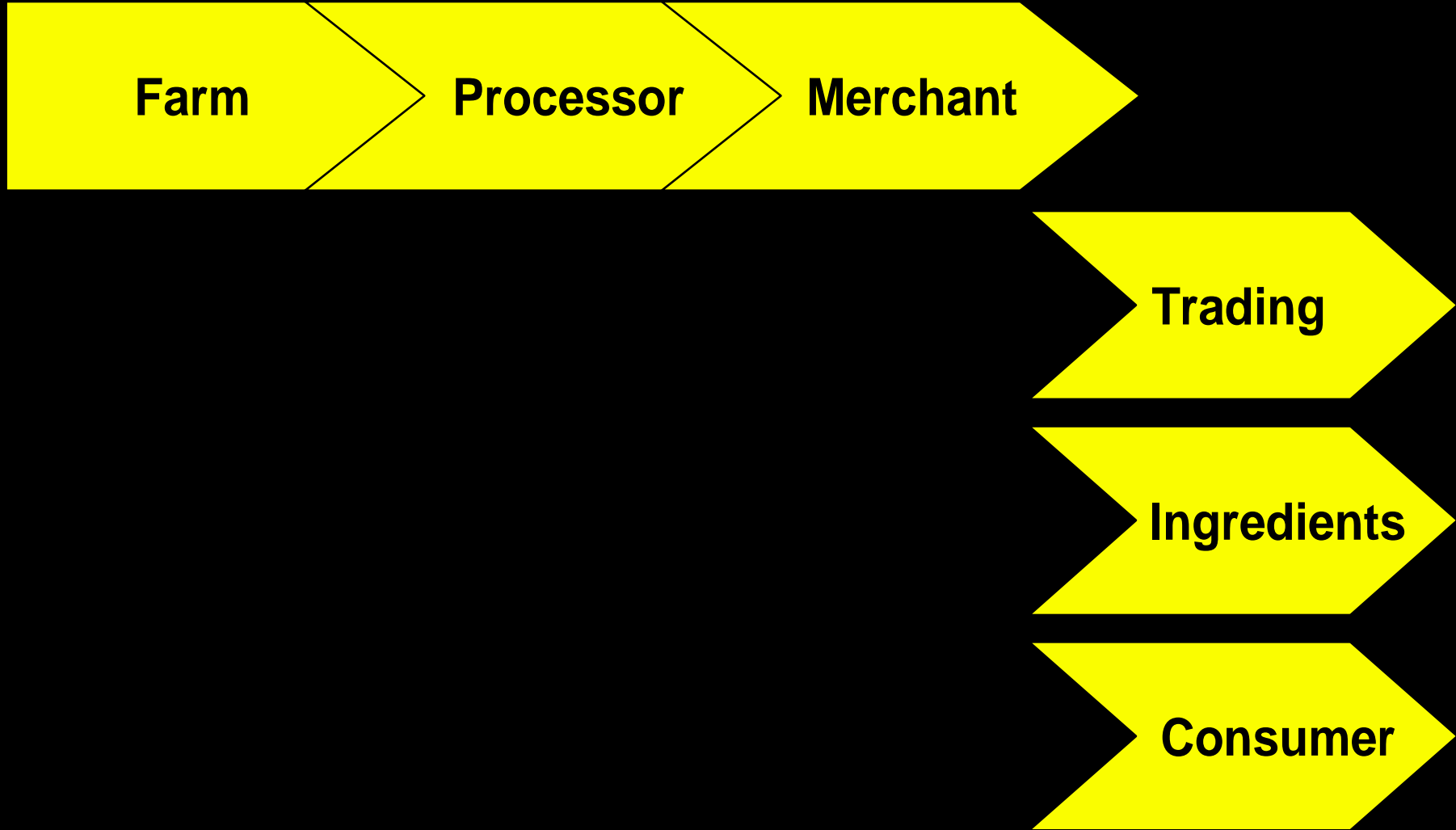
8

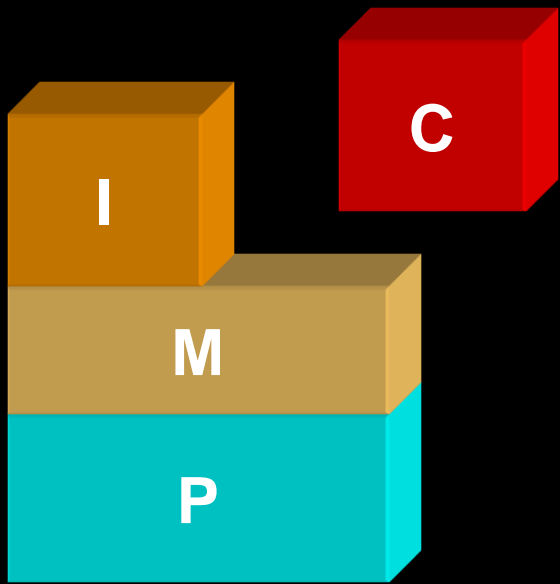
Additional capital required

4

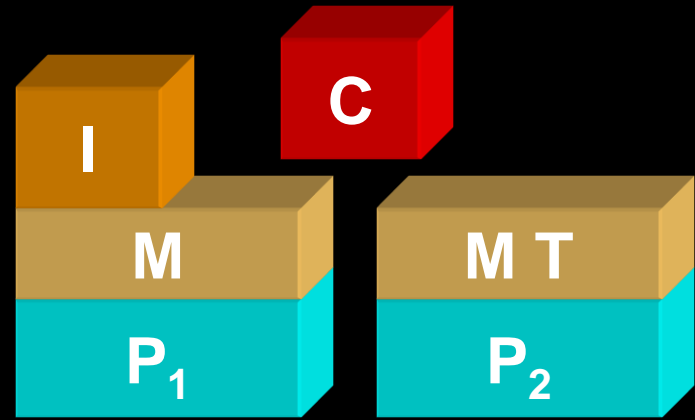


# SUPPLY CHAIN STRUCTURE - SIMPLIFIED

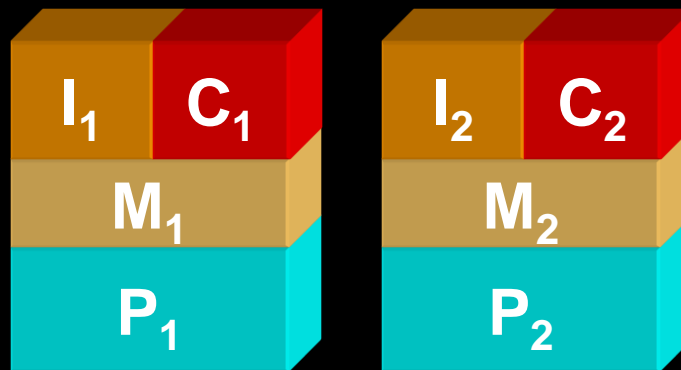




*OPTION 6*



*OPTION 3*



*OPTION 4A*

# CAPITAL / OWNERSHIP QUESTIONS

**External /  
Internal  
equity**

- Do we need to structure parts of the business to provide for external equity?

**Yes**

**Corporate  
vs  
co-operative**

- Should the Industry maintain a co-operative ownership structure for all parts of the business?

**No**

**Ownership  
Linked/  
Delinked to  
Supply**

- Should returns from downstream investments be delinked from supply?

**Yes**

**Differentiated/  
Uniform  
Payout**

- Should the Industry have the ability to differentiate payout?

**Current  
No\***

\* Constitutional change required

# ECONOMIES OF SCALE BENEFITS: MANUFACTURING

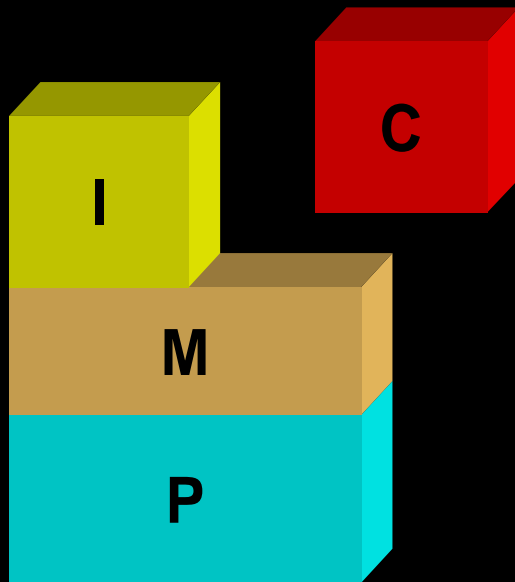
\$ millions annual savings

	One Company	Two large companies
Total synergies	50 - 80	35 - 55



Difference between one and  
two large manufacturers is  
\$15-25 million pa

## OPTION 6



**Consumer separate subsidiary.**

**Single company for processing, merchandising and ingredients**



## **SUMMARY**

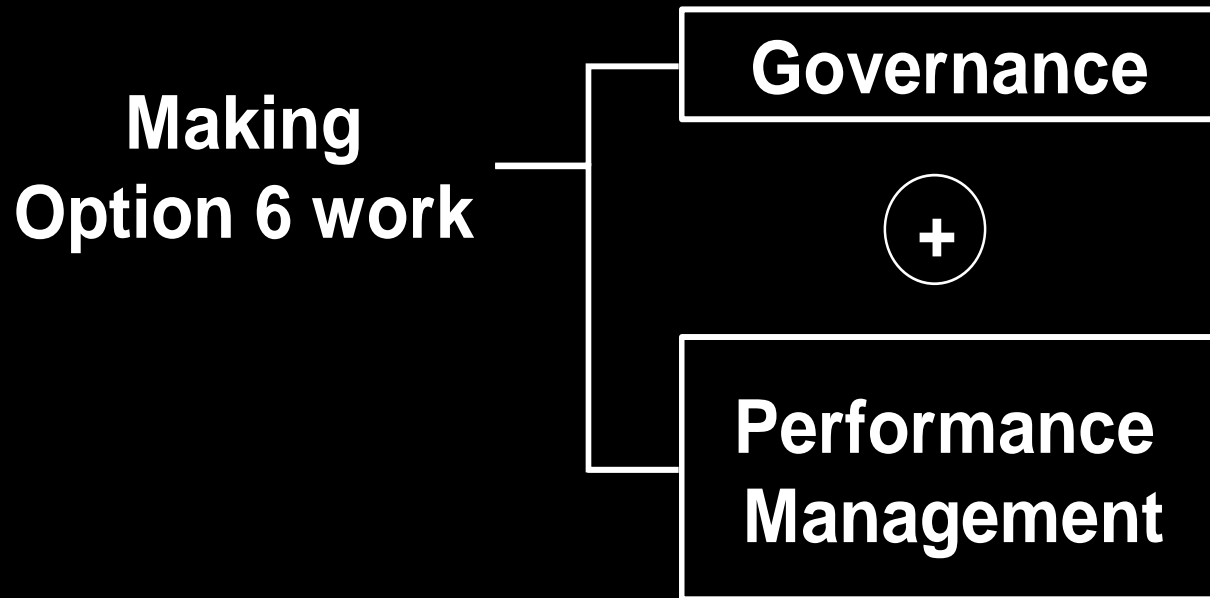
**Option 6 is preferable to a pure Option 3 by \$800 million if x-inefficiency can be eliminated**

**Otherwise a pure Option 3 is preferable to Option 6 by \$300 million if breakdown of Option 3 can be prevented**



**We believe that the x-inefficiency can be managed under Option 6**

# MAKING OPTION 6 WORK



# EFFECTIVE PERFORMANCE MANAGEMENT

## Challenges

- No transparent milk price
- Administered product prices



## Principles

- Replicate the market



## Solution

- Single independently administered NZ milk price
- Arms length based transfer prices



- “Big company”
- Diverse and complex

- Provide farmer choice
- Organise around small performance cells



- Separate off areas of business specialisation
- Accountable, autonomous performance cells
- Aggressive targets

# Comparion of 1999 and 2001 merger proposals

FEATURE	2001	1999
Goal: to grow sales to \$30 billion in 10 years	Yes	Yes
Goal: to save \$300m pa	Yes	Yes
Merge Dairy Board, Kiwi and NZ Dairy Group into one mega co-operative	Yes	Yes
Deregulation in 12 months	Yes	Yes

Commerce Commission approval required	No	Yes
Sell 50% of NZ Dairy Foods	Yes	Yes
\$15 billion of new capital	?	Yes
An extra \$4 billion of new share capital from non-farmers	Promoters now say no	Yes
Separate 'A' shares for manufacturing + exporting of NZ milk	No	Yes

Separate quota shares ('Q' shares) for farmers	No	Yes
Trading of 'A' shares among farmers within band of 80-120% of supply	No	Yes
Farmer choice to invest in new overseas consumer-market ventures	No	Yes
Separate vehicle to for new overseas consumer-market ventures	No	Yes
Relative simplicity of withdrawing capital	Lower	Higher

FEATURE	2001	1999
Avoid special Government regulations and regulator to oversee mega co-op	No	Yes
Requirement on mega co-op to sell milk to competitors	Yes	No
6 year phase-out for automatic holding of quota rights by mega Co-op	Yes	Yes
Farmer-owned Quota Company to hold and tender quota rights after 6 years	No	Yes



# McKinsey's claimed benefits

Previously identified (BDP/IEIS)	130
Integration of manufacturing	50
Interface simplification	30
'Catalytic event'	<u>100</u>
Total	<u>\$310m</u>

## \$8b Merger

Industry claimed gains: \$180m

### Commerce Commission draft view:

Maximum gross gains: \$92m

Productive efficiency losses: -\$192

Dynamic efficiency losses: -\$500m

# 2000/01 Negotiations

# Change in people

## NZDG:

Chairmen: 1998 – 2002

Spring → Storey → Leader → Van der Heyden

CEOs: 1998 – 2002

Footner → Milne → Spencer

## NZ Dairy Board:

Chairmen: 1998 – 2002

Spring → Storey → Fraser → Roadley → Van der  
Heyden

# Differences of philosophy

Pure co-op + single  
exporter:

Spring

Roadley

Young

Gent

Booth

Bayliss

More corporate + competing  
exporters:

Storey

Fraser

Calvert

Allison

Van der Heyden

Rattray

Townsend



No longer directors

# Kiwi Dairy

# NZDG

Pure co-op view



More corporate view

Single entity



Two competing exporters  
*(Project Eagle)*

No outside directors



Yes outside directors

Norgate as CEO



Someone else

No



Corporate mechanisms

Equal value shares



No

No



NZDG control of Dairy Boa  
*(58% control)*

NZ Milk as co-op



Partial float

Wellington, Oct 13, 1998, NZPA - Retiring Dairy Board chairman Sir Dryden Spring today put the boot into the Government's plan for the deregulation of producer boards, describing it as a "gigantic economic hoax"

"Dairy Board chairman Sir Dryden Spring is adamant the industry...will remain farmer-owned and continue selling through a single marketer owned by the co-operatives following deregulation"

## Decision 2001

In Brian Edward's biography –

PM comments that she “shot a line across officials” and gave directions that the legislation was to be prepared authorising the merger.

It appears that Dryden Spring was a key player



# Part 3: Changes

- Nature of Fonterra
- Four fundamentals
- Eight specifics
- Drivers of change

Fonterra is a structure in transition:

**From** serving producers and appeasing their competing perceptions of fairness

**To** serving customers – to capture the value they put on different products and services

## Key changes needed

- Farmers need to receive from Fonterra real signals of how customers value their products
- Fonterra needs to receive from shareholders real signals of how they value Fonterra's performance.
- Farmers need to develop new skills to participate as shareholders, not just as producers
- Directors need to provide some real leadership

## Key changes needed *(cont'd)*

**Volume + price** – F would offer suppliers a choice of contracting options, eg –

- fixed volumes at fixed prices set in advance;
- no fixed volume at 'spot' prices; or
- part fixed, part open.

**'Surplus milk'** – F would pay the true marginal value of 'surplus' milk (ie it charges full costs for processing an extra unit of milk)

**Dividends** – Paid out to farmers as a separate dividend (esp NZ Milk)

## Key changes needed *(cont'd)*

**Share value + monitoring** – Make F's co-op shares are tradable among farmers within 80-120% of their supply

This would provide on-going (not just annual) and multiple (not just a single valuer's) signals to F of how shareholders value its performance. It would also significantly reduce F's current 'redemption risk', which is like a 'run on a bank', where farmers all at once want to cash up their F shares. To mitigate this risk, F has put in place a number of devices, including its option to redeem not with cash, but by issuing redeemable preference shares and capital notes. F has also imposed a tight window on when shares can be redeemed.

## Key changes needed *(cont'd)*

**Value added business** – Separate NZ Milk. Share tradable among farmers. Later open to outside investors (up to say 49%).

**Board of directors** – Reduced to nine as originally proposed.

The current number (13) is simply a carry over from the Dairy Board and (before that) the Dairy Products Marketing Commission (since around 1947)

**Diversify beyond milk** – Use skills and some risk capital to capture margins in new markets

# Key changes needed *(cont'd)*

## F reduce market share in NZ –

Sell down enough of F's business in NZ (10 – 15%) to end restrictions of Government regulations.

Gains from maintaining a near-monopoly in NZ, particularly in processing raw milk, are unlikely to outweigh the costs.

Between 1890 and 1920, the market for processing raw milk was highly competitive in NZ. The 'co-operative culture' viewed this competition as 'pernicious' as some co-operatives failed.

Introducing a competitive environment is likely to boost F's performance, to the benefit of farmer-shareholders.

# Drivers of change

- **Consumer competition** – need to be more customer driven and less capital constrained
- **Supplier expectations** – ‘big’ vs ‘small’, and generational change

Over time, pressure will grow for cross-subsidies to be removed, leading to user-pays transport costs, fixed collection fees and regional milk payouts



“The story of two Henrys”



Henry Reynolds

In **1886**, Henry Reynolds created "Anchor" brand



Henry Nestle

In **1867**, Henry Nestle created "Nestle" brand

Two different paths, two different strategies.  
How did each business fare?



**Henri Nestle** was a merchant and small-scale inventor.

1867: Invented the world's first solid **infant formula** using Swiss milk

1905: Moved into **condensed milk**

1929: Moved into **chocolate ('Nestle')**

1930s: Moved into **coffee ('Nescafe')**

Not coffee (beans) the commodity. Nestle created freeze dried and granulated instant coffee.

1947: Purchased **Maggie**

1963: Purchased frozen food giant **Findus**



**Henri Reynolds** was a  
businessman.

1896: Sold factories to NZ Dairy  
Association

[ ]: Merged to form **the 'Big Octopus'** –  
NZ Cooperative Dairy Company

**'Anchor'** brand remained tied to one key  
product – NZ butter in England

# Conclusion

- Industry founders' shared goal was to be 'free men'. Not servile or afraid
- The goal has not been achieved
- The key is thinking with a 'free mind'. Look outside the box

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