Apocalypse Cow:

Why Fonterra has failed

Peter Fraser

Presentation: Institute of Governance and Policy Studies

28 June 2019

Revised 19 August 2019

Getting to ‘why’ Fonterra has failed

- Fonterra never achieved the disruptive change expected – basically a BAU story: **Why?**
- It never had the money to do much else: **Why?**
- Weak balance sheet: **Why?**
- Too much debt, not enough retentions: **Why?**
- Post 2010, Fonterra paid too much for the milk it **buys**: **Why?**
- Because its owners **sell** milk….

Farmers’ primary objective is to create value ‘on farm’ – owning a factory is merely a means to that end: ***it isn’t an end in itself***

The counterfactual: Kerry

- Irish Coop that listed and turned itself into a diversified food company – now worth €19B
- Huge success: shares worth the equivalent of €0.50 in 1986 are worth ~€105 now
- In the 1980s, EU milk quotas were imposed on Ireland; so farmers could not increase wealth ‘on farm’ via increased production
- Therefore focused ‘at factory’
- And that’s the simple reason Fonterra never became a ‘NZ Kerry’ – NZ’s farmers focused ‘on farm’.

Presentation structure

- *The promise*
- *The reality*
- *The why*
- *The where to*

Fonterra™

Dairy for life

Section 1: *The Promise*

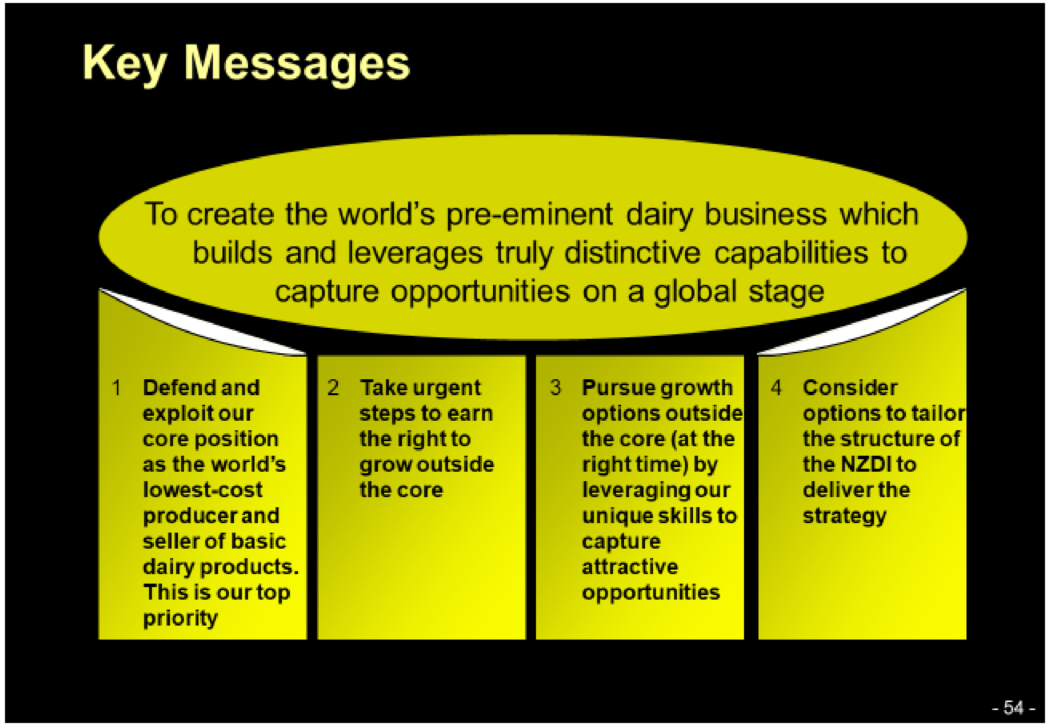
Let’s go back to the very beginning…

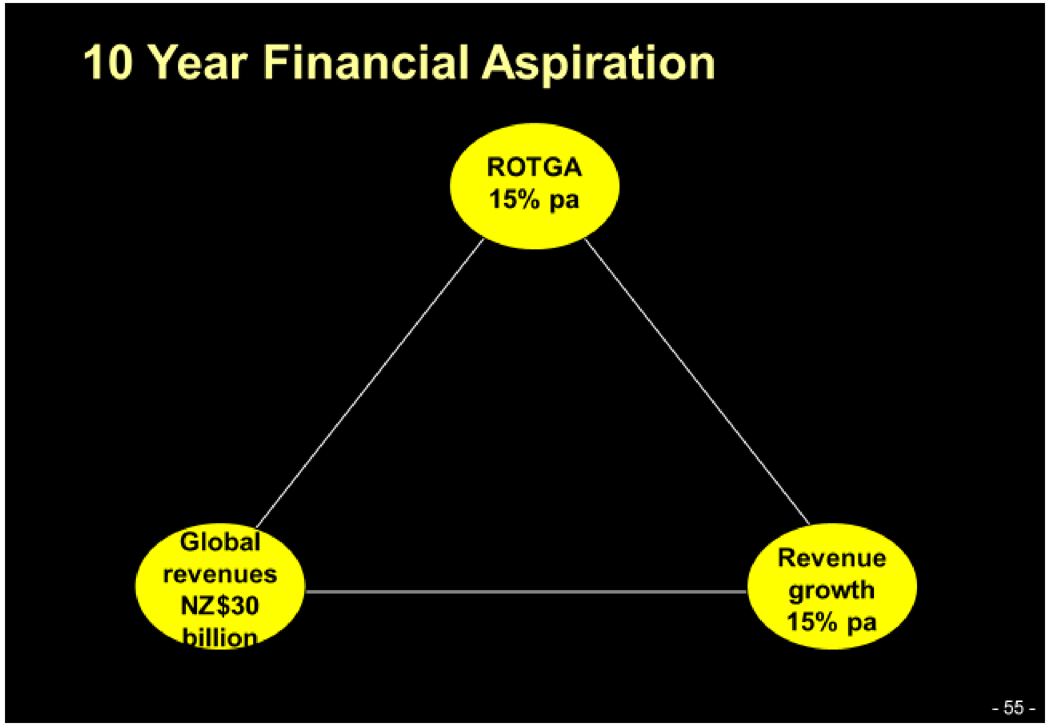
Three issues

- *Farmer ownership and control of processing*
- *Long run processor agglomeration*
- *Producer board reform*

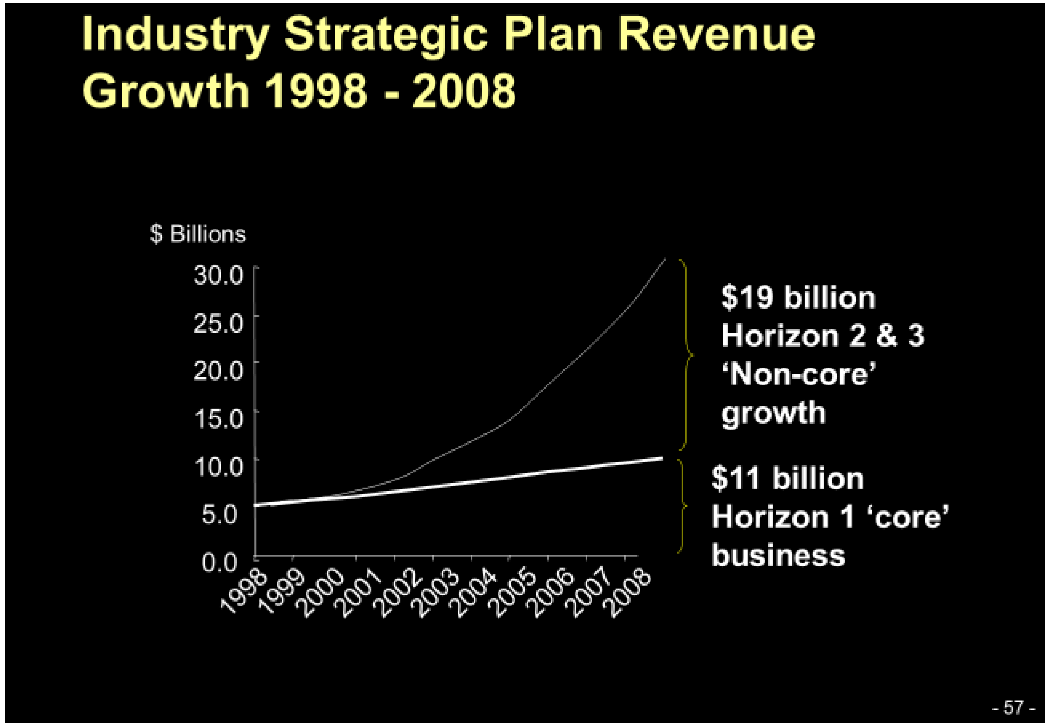
While the direction of travel was clear – the destination was ‘up for grabs’

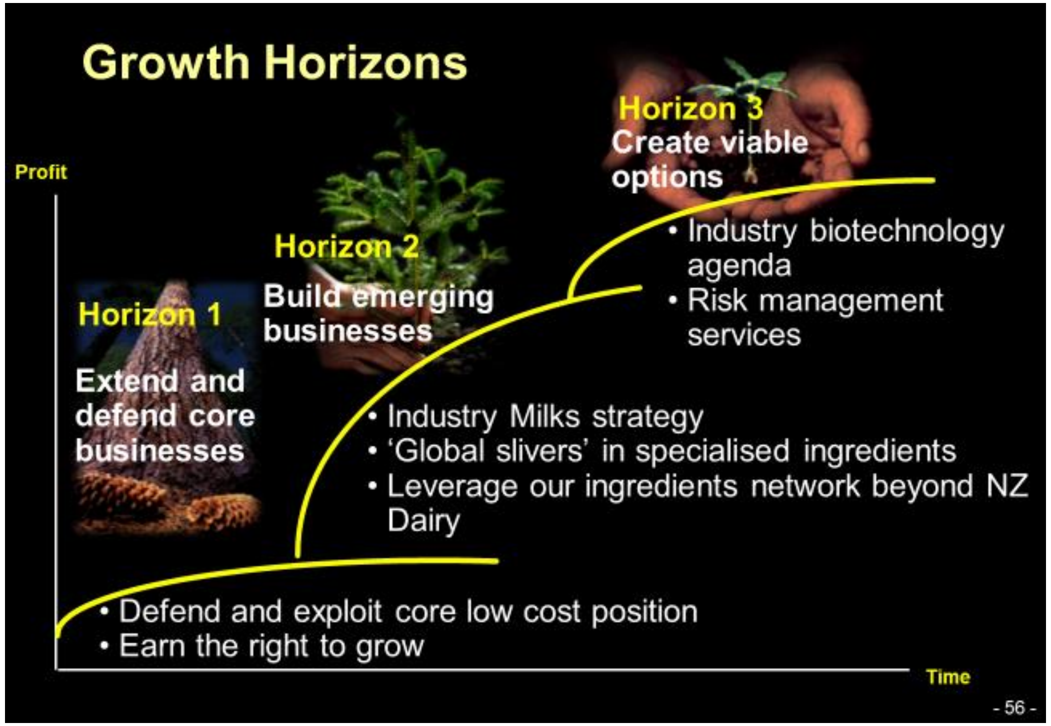
The 1999 Select Committee Presentation





....but wait, there's more...





The dairy industry talked a very big game... so what was the catch...?

The *moo*-nopsony and the *moo*-nopoly

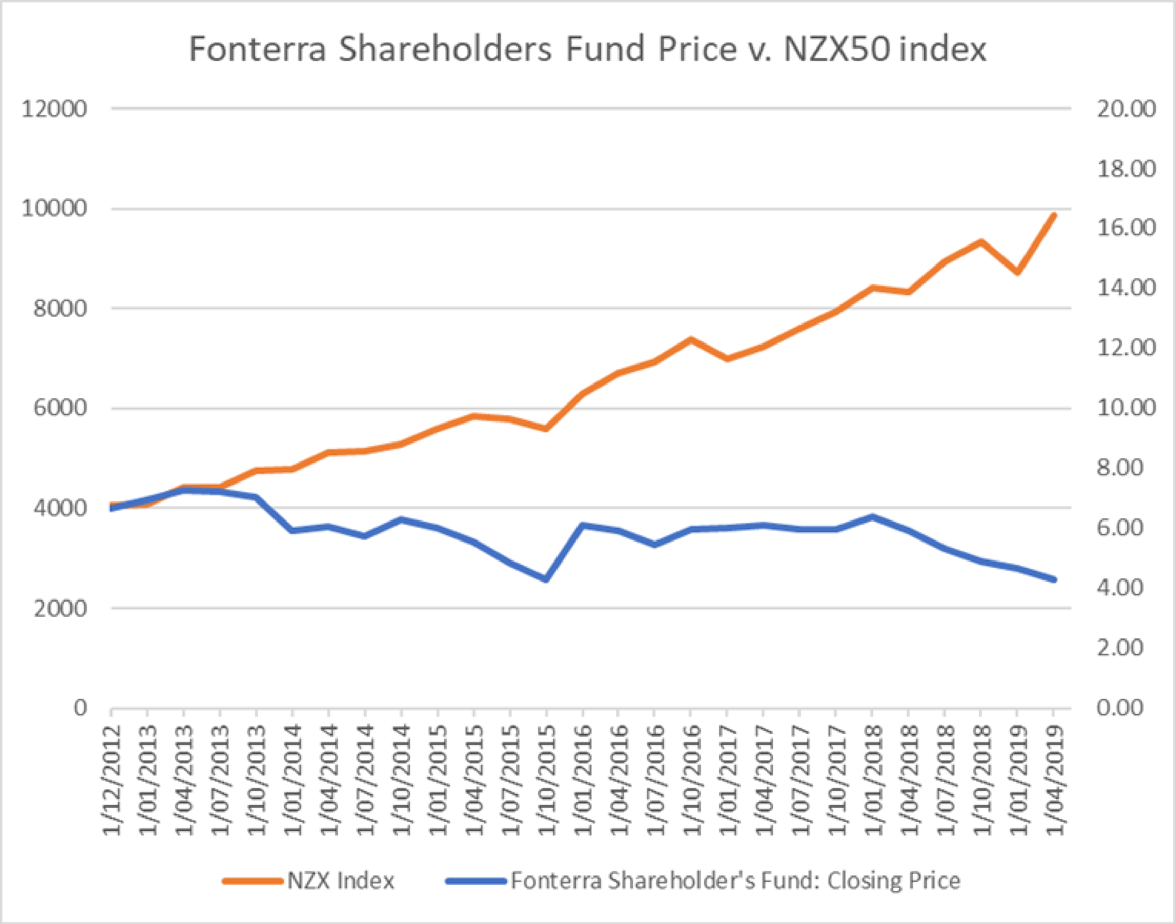
- ***1999*** *– 'Mega Merger' proposal taken to ComCom –* ***rejected***
- ***2000*** *– 'GlobalCo' taken to Government – sought an exemption to the Commerce Act –* ***accepted***
- ***2001*** *– DIRA – exemption granted but company-specific competition policy built around 'New Coop'*

…so, while ComCom didn't buy it, politicians (with the exception of ACT) did…

Section 2: *The Reality*

‘Failed the thrive’

- Fonterra launched TAF in late 2012
- From an issue price of $5.50 units immediately rose to $6.67 – so a 21% ‘stag’
- Units peaked at over $8.00 in early 2013, after which point they diverge from the NZX50 and ‘never the twain shall meet’



…but is a comparison to an index fair?

…how about industry peers?

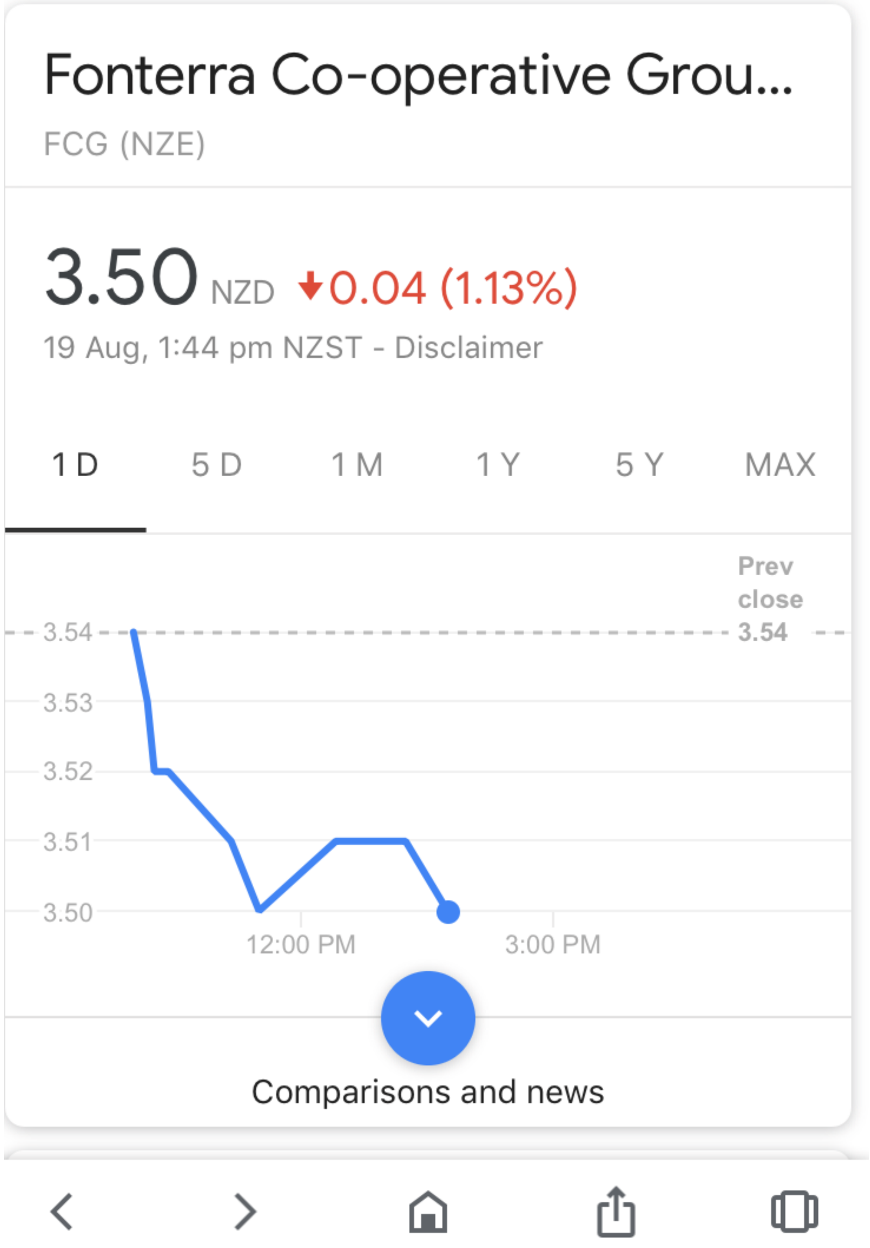
Company	Share price: Dec 2012	Share Price: 31 May 2019	Change (%)
Danone	€50.10	€71.40	+42.5
Nestle	CHF 60.95	CHF 99.55	+63.3
Kerry Group	€40.60	€103.90	+155.9
Synlait Milk	$NZ 2.71 (**NB**: Aug 2013 listing)	$NZ8.87	+227.3
Fonterra	**$NZ 6.67**	**$NZ 4.00**	**-40**

Company	Share price: Dec 2012	Share Price: 31 May 2019	Change (%)
Xero	5.95AU	59.81AU	+905
Fletcher Building	**8.26NZD**	**5.25NZD**	**-36.4**

No matter how you want to cut it – Fonterra's performance is astonishingly poor

Fonterra closed yesterday at one cent below its initial 2002 share valuation of $3.85….


REVISED


Fonterra Co-operative Grou...
FCG (NZE)
3.50 NZD ↓0.04 (1.13%)
19 Aug, 1:44 pm NZST - Disclaimer
1 D
5 D
1 M
1 Y
5 Y
MAX
Prev close 3.54
3.54
3.53
3.52
3.51
3.50
12:00 PM
3:00 PM
Comparisons and news

Fonterra's race to the bottom

- ***June 18:*** *~$8.2B company*
- ***Jan 19****: ~$7.4B company with $7.3B of debt with a $6.5B debt target*
- ***May 19****: ~$6.4B company with a $6.5B debt target…*
- ***June 19****: ~$6.2B company…*
- ***August 19:*** *~ $5.6B company*

Fonterra is losing value faster than management can set assets – that's not likely to end well

Great? Good? Also ran?

- Fonterra hasn't lived up to the hype and created 'astonishing' value, but that's forgivable
- But it hasn't been a good BAU company **either**: it's a serial value destroyer – and that's not
- Even worse, it's selling the 'interesting bits' – and OCD is already caning Fonterra regarding 'the boring bits'.

Issue is whether Fonterra can survive – especially in a world of peak cow

Section 3: *The 'why'*

Starters for 10

- *Beingmate/Danone/China Farms*
- *Failure to 'turn the wheel'*
- *Too much debt*
- *Modest to nil retentions*

Cash-strapped coop that either made poor investments choices – or got poor results

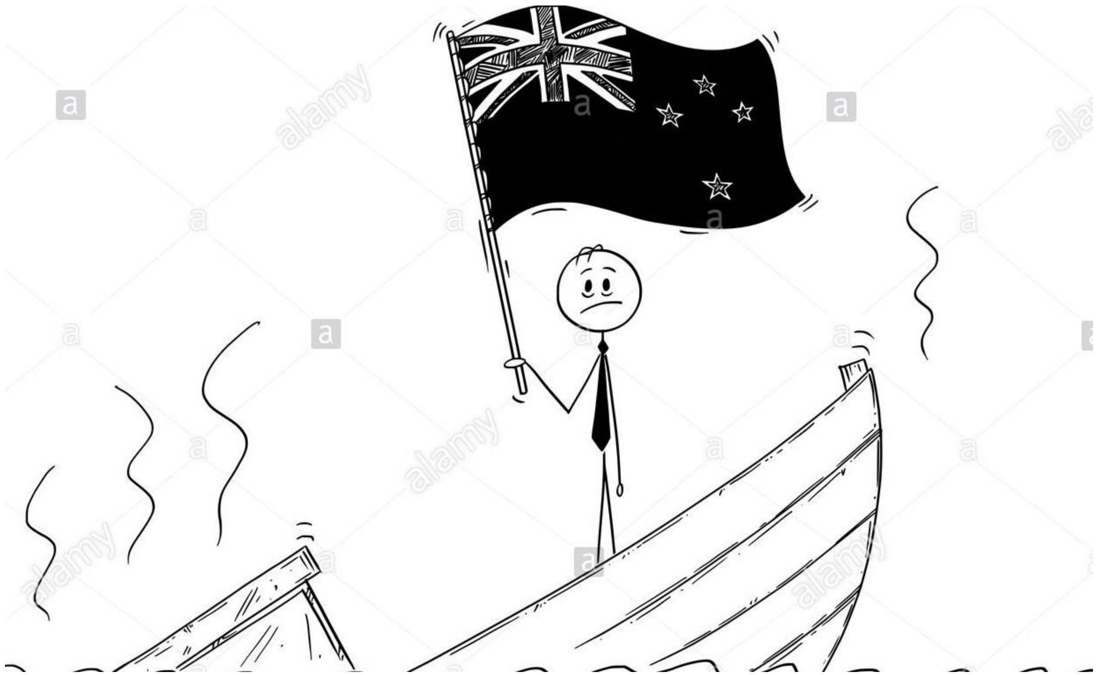
Fonterra’s imaginary friend

- ***HEC** – imaginary performance of an imaginary processor making imaginary products*
- *A transfer pricing story: Fonterra takes ~50 cents from payments to capital (dividends, retentions) and instead pays it out as a ‘stretched’ milk price*
- *That’s a ~$750 million per annum mispricing – and at a P/E of 10, a ~$7.5B under pricing of Fonterra*

Farmers like this: high milk price/high land price/low share price

Consequences

- **Fonterra**: Margin squeeze – forcing it to be a giant OCD
- **Competitors**: Vertical foreclosure – sub-optional level of innovation
- **Farmers**: Inflated land prices, too much debt, too many cows
- **Environment**: Water and GHG story



Welcome to ECON1 and what happens when you distort input prices

Section 4: *The 'where to'*

Caught in a trap and I can’t get out…

- *Fonterra sets the oddly named ‘Base Milk Price’ and argue they must pay it*
- *Retentions – didn’t, but now can’t*
- *Split off consumer goods business – but need asset sales to repay debt*
- *Risk of abandoning the MPM (again) – units tank (again)*

Cleaning up the mess

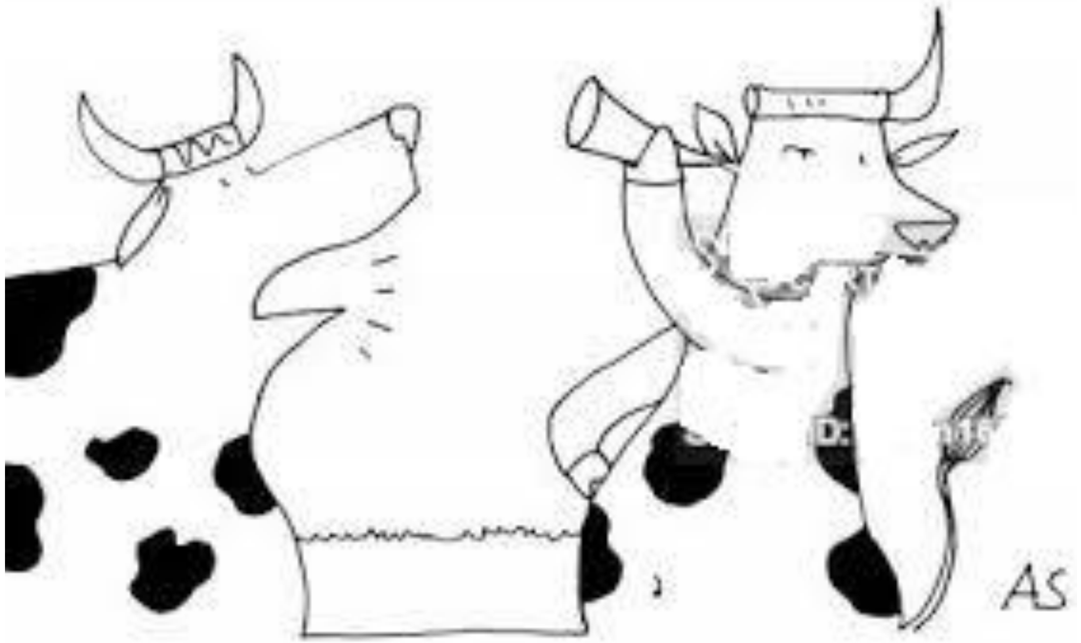
- Fonterra
  - 50 cents off the milk price in 19/20 and used as debt repayment
  - Restore dividend to at least 20 cents
- Government
  - Independent setting of the ‘Hypothetically Efficient Milk Price - but Fonterra sets its own farm gate milk price
- Competition Policy
  - Milk must be able to go to its highest value users and use - DIRA becomes even more critical

What is the government doing?

- DIRA is Government's key lever

- The government needs to fix what *isn't* working in DIRA (i.e. setting the BMP) and leave well alone what *is* (i.e. the pro- competition measures in DIRA)

- What government is doing is minor tweaking to the milk price setting regime and weakening the pro-competition measures



So it's doing the opposite of what needs to be done

Take home messages

- If what you wanted was an entrepreneurial or science-driven growth company then a farmer owned dairy cooperative, with farmers controlling their own milk price, is about the worst structure you could have possibly come up with: Fonterra was doomed from the start
- Fonterra's performance has been woeful for ages – but it works for farmers: it's a successful private wealth creation scheme – it's just a pity about everyone else
- Fonterra is not a national champion and never will be – it's actually a drag on the entire economy
- Government has the ability to remove the worst excesses of the milk price setting regime but it looks like it has fluffed its chance
- Westland was a dress rehearsal: Fonterra is the main event

So, where's the ultimate 'cause'?

Thank you for listening. Are there any questions?

Peter Fraser

Peter Fraser is a living embodiment of flexible labour markets and a testament to the lengths people will go to avoid toxic organisations and people.

Peter is a ‘sometimes’ guerrilla economist, who in previous lives has worked for a myriad of Government departments and agencies, including the Treasury and MAF Policy (now MPI). Peter is interested in pretty much everything, but his current interests include dairy industry and irrigation issues; where he has advised clients ranging from independent dairy companies to NGOs.

Peter is Wellington-based and operates as Rōpere Consulting.

Rōpere Consulting Limited

Rōpere is the Māori word for strawberry, which at first glance is a strange name for a consultancy.

A hint can be found in the French word for strawberry, which is *fraise*. *Fraise* was also the name granted to a French nobleman Julius de Berry, who, according to legend, was knighted after giving the King of Normandy a magnificent plate of strawberries out of season – a miraculous feat in a time before the advent of 24 hour convenience stores.

De Berry’s decedents travelled with the King’s decedents and fought a particularly noteworthy battle in 1066. The family, however, decided to continue north, and eventually ended up in the Highlands of Scotland – whence they then spread across the globe.

In the process the name was anglicised to *Fraser.*

RŌPERE CONSULTING

Incredible Credible

Conflict of Interest Statement

Peter Fraser is currently contracted to an independent dairy company to provide economic and competition policy advice associated with the current Government Review of the DIRA.

Peter is also a member of the ad hoc Ministerial DIRA reference group.

RŌPERE CONSULTING

Incredible Credible

Extra slides for question time

NZ CORPORATE ***REPUTATION*** INDEX

Ranking	*Change since 2016*	*Company and 2016 ranking*
1	–	**Air New Zealand** *1*
2	–	**Toyota NZ** *2*
3	*+3*	**ASB** *6*
4	*–1*	**The Warehouse** *3*
5	*+3*	**Zespri** *8*
6	*+1*	**Foodstuffs** *7*
7	*+7*	**ANZ** *14*
8	*New*	**Mainfreight**
9	*–5*	**Z Energy** *4*
10	*–5*	**NZ Post** *5*
11	–	**Fulton Hogan** *11*
12	*+3*	**Woolworths NZ** *15*
13	-	**Genesis Energy** *13*

Ranking	Change since 2016	Company and 2016 ranking
14	+4	**TrustPower** *18*
15	-3	**Meridian Energy** *12*
16	-6	**BNZ** *10*
17	-8	**Vodafone** *9*
18	+1	**Spark NZ** *19*
19	-2	**Westpac** *17*
20	–	**Contact Energy** *20*
21	+2	**Fonterra Cooperative** *23*
22	-6	**Fletcher Building** *16*
23	-2	**BP NZ** *21*
24	–	**ExxonMobil NZ** *24*
25	*New*	**Housing NZ**

https://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=11844603

Fonterra failed to see 'explosive reputational risk'

29 Oct, 2013 4:05pm

An independent inquiry into Fonterra's botulism debacle has found the dairy giant failed to recognise the "explosive reputational risk" involved in the scare.

The inquiry - which was commissioned by the dairy company's board - today released its findings and recommendations at a media briefing in Auckland.

A list of "things that went wrong" included the "belated recognition (and delayed escalation to senior management and the board) of the explosive reputational risk involved".

Fonterra had failed to "join the dots" between botulism, infant food products, consumer sensitivities, and Fonterra's global reputation, the report said.

https://www.nzherald.co.nz/the-country/news/article.cfm?c_id=16&objectid=11148131

Northington Partners

FONTERRA SHAREHOLDERS' COUNCIL

Fonterra Dairy for life

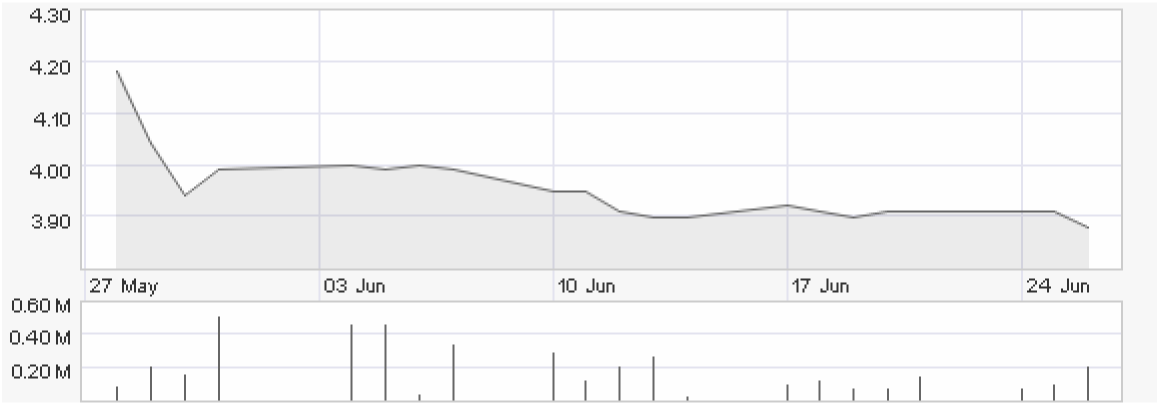
Executive Summary

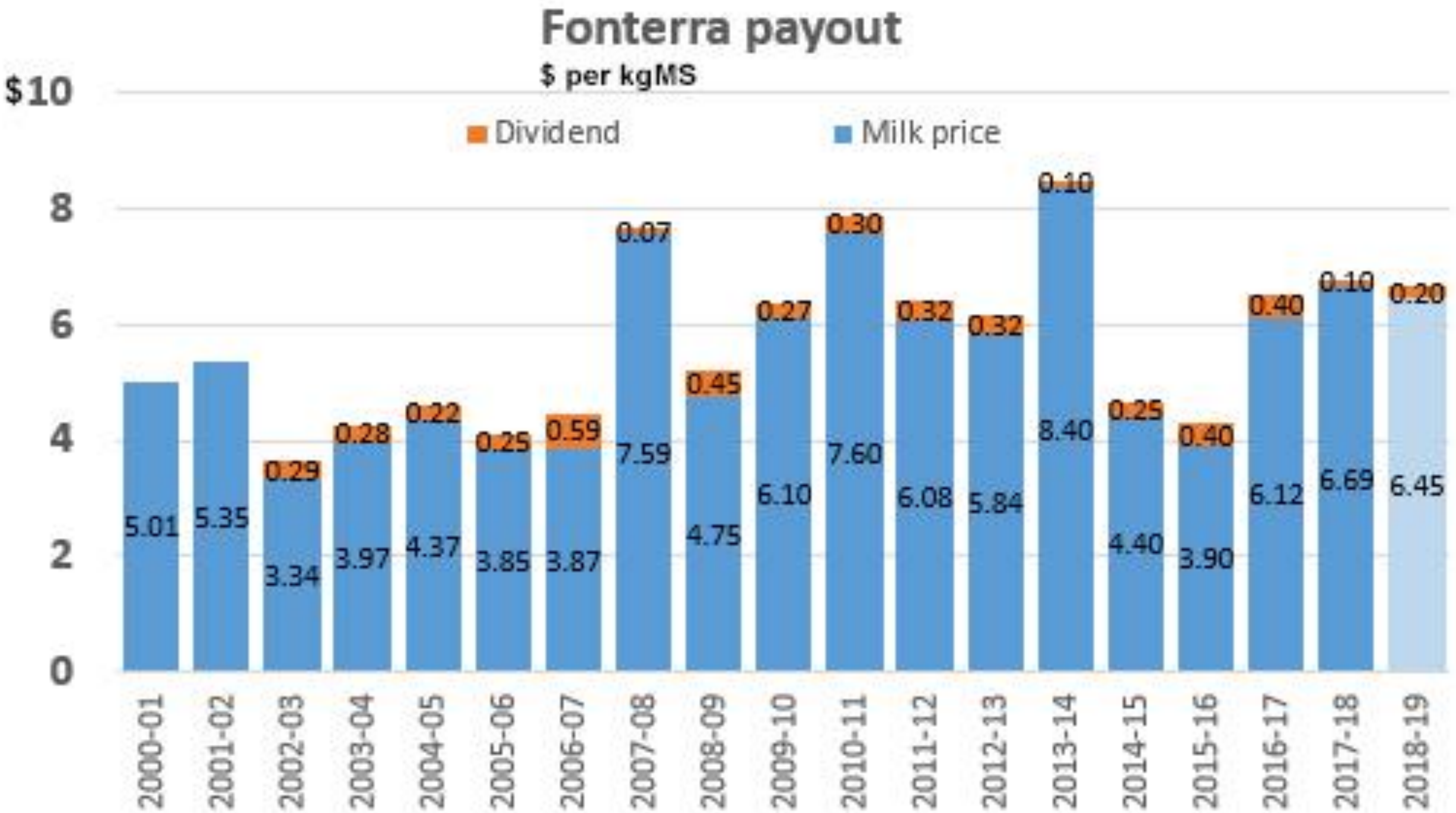
Metric Examined	Measured By	Fonterra's Performance
Shareholder Returns	What was the average **Total Shareholder Return** (Change in Share Price + Dividends) since inception?	**$1** invested in Fonterra would be worth **$2.84** today (before taxes), representing a **6.3% p.a.** return
Financial Performance	What was the average **Return on Capital Employed** since inception and was this in line with appropriate benchmarks?	Fonterra's Return on Capital has averaged **6.0% p.a.** (post-tax), which is lower than the assessed benchmark of **6.9% - 7.7% p.a.**
Segment Performance	How much higher was the **Value-Add** business Return on Capital compared to the **Ingredients** business, and was this sufficient to compensate for the increased risks?	The Value-Add business returned **0.2% p.a.** more than Ingredients, significantly below the **1.3% p.a.** premium needed to justify the increased risk.
Other Contributions to Farmer Wealth	Farmers should also take into account: 1. The gap has closed between the NZ milk price and international prices since Fonterra's formation. 2. There has been a significant increase in the Milk Price since the inception of the Milk Price Manual. 3. The value of farm land has increased since Fonterra's formation (even after adjusting for productivity improvements on-farm). 4. Fonterra's performance includes the impact of ongoing support and stability during weak economic conditions.	

1 Year

3 Months

1 month




Fonterra payout
$ per kgMS
Dividend
Milk price
$10
8
6
4
2
0
2000-01
2001-02
2002-03
2003-04
2004-05
2005-06
2006-07
2007-08
2008-09
2009-10
2010-11
2011-12
2012-13
2013-14
2014-15
2015-16
2016-17
2017-18
2018-19
5.01
5.35
3.34
0.29
3.97
0.28
4.37
0.22
3.85
0.25
3.87
0.59
7.59
0.07
4.75
0.45
6.10
0.27
7.60
0.30
6.08
0.32
5.84
0.32
8.40
0.10
4.40
0.25
3.90
0.40
6.12
0.40
6.69
0.10
6.45
0.20

Fonterra				Tatua		Westland			Synlait	Open Country	Miraka	Oceania Dairy*
Controlled by	Co-operative				Co-operative		Co-operative		Bright Foods	Talleys	Māori trusts	Yili
$/kgMS	Milk	Dividend	Total	Retention	Milk	Retention	Milk	Retention	Milk	Milk	Base	Milk
	$	$	$	$	$	$	$	%	$	$	$	$
1998-99			3.58									
1999-00			3.78									
2000-01			5.01		5.52							
2001-02			5.35									
2002-03	3.34	0.29	3.63									
2003-04	3.97	0.28	4.25		4.39							
2004-05	4.37	0.22	4.59		4.32							
2005-06	3.85	0.25	4.10		4.59					3.90		
2006-07	3.87	0.59	4.46	-0.00	4.10		4.72			4.22		
2007-08	7.59	0.07	7.66	-0.24	8.00		7.99			7.38		
2008-09	4.75	0.45	5.20	-0.01	5.38		4.58		5.03	4.93		
2009-10	6.10	0.27	6.37	-0.33	6.32		6.15		6.31	6.07		
2010-11	7.60	0.30	7.90	-0.25	8.10	-0.58	7.70	-0.30	7.76	7.56		
2011-12	6.08	0.32	6.40	-0.10	7.50	-0.54	6.04	-0.10	6.22	6.18	6.18	
2012-13	5.84	0.32	6.16	-0.14	7.40	-1.17	6.34	-0.10	5.89	5.75	5.94	
2013-14	8.40	0.10	8.50	-0.00	9.00	-1.32	7.57	-0.30	8.31	8.41	8.50	
2014-15	4.40	0.25	4.65	-0.04	7.10	-0.63	4.95	-0.10	4.54	4.61	4.50	4.50
2015-16	3.90	0.40	4.30	-0.11	6.41	-0.11	3.62	+0.26	4.02	3.94	4.00	4.50
2016-17	6.12	0.40	6.52	-0.06	7.60	-0.50	5.18	-0.20	6.30	6.06	6.23	6.22
2017-18	6.69	0.10	6.79	-0.00	8.62	-0.52	6.12	-0.05	6.78	6.71	6.80	6.84*
2018-19	6.30-6.60	0.15-0.25	6.45-6.85				5.80-6.00		6.25-6.40			6.30*
2019-20									**7.00**			
		see Note below										* Oceania pay the Fonterra milk price, plus 15c.