How do Dairy Co-operatives Grow for Farmers' Benefit?

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1. Introduction

1.1 New Zealand Must Grow

New Zealand must grow. We lag Australia in Gross Domestic Product (GDP) by around $64,000 per family, slipping from near the top of the developed world in 1970 to near the bottom in 2010 [1].

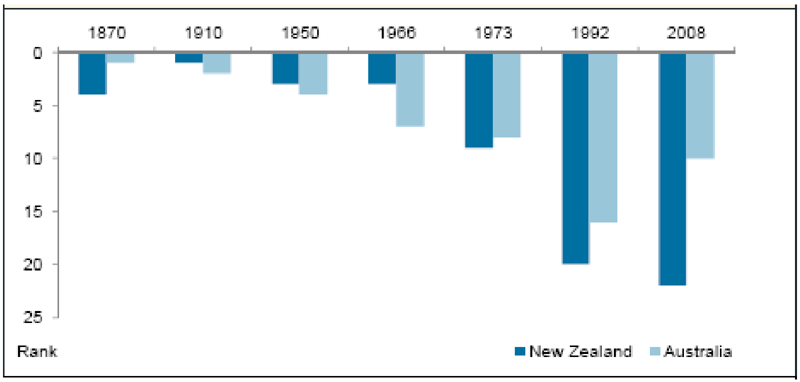

Figure 1: New Zealand GDP Per Capita Ranking Compared To Australia[1]

The solution to this problem must deliver real cash into New Zealanders pockets. Gross income is the key as total cash oils the wheels of economic enterprise. Individual New Zealanders must succeed.

1.2 Dairying Must Grow

The rest of the world has a negative correlation between agricultural earnings and GDP[2]. Agriculture makes only a small proportion of GDP in the world's richest nations. New Zealand is different. In contrast to the rest of the developed world, our largest earner is agriculture, and a significant portion of that is dairying.

To grow as a nation, our largest company must help lead the way. Dairying is an example of private enterprise working well. Ten thousand farmers represent more than seven percent of New Zealand's GDP and 25 percent of the country's exports through their collective ownership of Fonterra Co-operative Group. They create $16 billion of revenues, putting real cash into our communities, to circulate. For every extra dollar earned by dairy farmers, $270 is generated for the economy[3] and the dairy industry has a velocity of money per annum of six to seven.

In an agricultural export nation, the foundation of our collective success is dependent upon farmers' ability to generate gross income, and then spend that gross income in our local communities. The bulk of money farmers earn is spent in New Zealand, and is reused again and again.

The position we find ourselves in sparks a number of questions. Is co-operative farmer ownership holding back our largest company, and our nation? Would opening this privately owned business to all New Zealanders deliver more or less gross income into New Zealand farmers' hands, and thus New Zealanders? Or, is the success enjoyed by dairying an example for other industries to follow?

1.3 Study Question

This Nuffield study seeks to answer the question:

How do Dairy Co-operatives Grow for Farmers' Benefit?

This question is approached from an ownership and governance perspective, rather than the perspective of executive. That is not to say that management are not critical for growth; they are. However, this Report concentrates on the elements that owners and government can influence.

Further, the question is seated in the context of the New Zealand economy and the country's goal to maximise the total cash income to the nation. In this context it is important that we understand how co-operatives maximise the fortunes of private individuals before we tinker with the golden goose... lest we lose the golden eggs. We must grow without putting the cash we currently have at risk. This foundation is too important to the nation and to our local communities.

I was granted six months study travel to answer this question. In all, this study has taken the best part of 15 months of preparation, travel, research and reflection. I visited Ireland, England, the Netherlands, the United States, Canada, China, Australia, Argentina and the Philippines. The study is exploratory, and thus inductive in nature. The findings should be read in that context.

I researched dairy businesses around the world, from all angles – from the company executives, directors, member councillors, to the farmers on the ground, and middle-tier employees, to members of parliament, industry commentators and analysts, totalling the best part of a thousand double-sided A4 pages of notes.

I have analysed more than 80 dairy company annual reports and have read widely. I have also drawn lessons from a number of businesses outside of dairy, as the opportunities arose during my Nuffield travel.

Dairy businesses that were studied include: Kerry Group Plc, DairyGold Co-operative Society, The Irish Dairy Board Co-operative, Dairy Farmers of Britain, Royal FrieslandCampina, Dairy Farmers of America and Land o' Lakes, amongst others. Case studies of these dairy businesses are found in the back of this report.

In researching the question, "How do Dairy Co-operatives Grow for Farmers' Benefit?" four common themes emerged:

Theme 1: Ownership Provides Purpose

For a co-operative to grow for the farmer, the farmer must own the co-operative.

Theme 2: Purpose Drives Strategy

For a co-operative to grow it must understand its purpose. Purpose is the destination. Strategy is a pathway. Structure is just a vehicle.

Theme 3: People Create Results

For a co-operative to grow farmers must invest in and develop their future governors.

Theme 4: Feed Your Golden Goose

For a co-operative to grow for the farmer, the farmer must own and invest in the business.

These lessons are explored in the following sections. First however, we explore the definition of a co-operative, establishing the foundation upon which this Report's findings rest.

2. Foundations

Key Insights:

- **Co-operatives are large equity partnerships**
- **Co-operatives are often created when markets are inefficient**
- **Co-operatives maximise cash into farmer hands**
- **Maximising cash into farmer hands maximises cash into the New Zealand economy**

2.1 Introduction

This section creates the foundation upon which this research is based. It defines what a co-operative is and explores the circumstances in which co-operative structures are commonly used.

2.2 What is a Co-operative?

Essentially a co-operative is an equity partnership between individuals with businesses in the same sector of the value chain who wish to invest for mutual advantage up or down the supply chain.

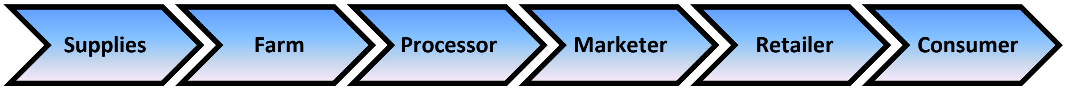

Figure 1: Basic Supply Chain

These equity partnerships are an extension of an individual's core business, and are recognised as such in law.[4] Co-operatives are pure businesses and exist to capture the economic benefits for its owner-members. Further, experts argue that investor-owned firms are really a sub-set of co-operatives[5] – opposite to layman wisdom.

Socialist characteristics are often attributed to co-operatives, but this is baseless[6]. Socialism is not a distinguishing feature of co-operatives, though it may develop in some, as is true of any business form.

Co-operatives are commonly formed in farming industries to overcome market inefficiencies. Farmers use co-operatives to create collective strength to overcome the market inefficiency. An example of such market inefficiency might be very high farm input costs, as was common in New Zealand in the 1960s. During that time farmers invested together upstream to create buying groups for their key farm inputs, and businesses such as Combined Rural Traders (CRT) were formed.

Another example of market inefficiency is where the price for farm produce is suppressed by stronger players within the value chain. It is recognised where the percentage of the consumer dollar that reaches the farmer does not match the risk and investment placed in that portion of the supply chain. Dairy farming is an excellent example of this market inefficiency.

2.3 Co-operatives Correct Inefficient Markets

Dairying is an inherently inefficient value chain[7]. Raw milk only has a shelf life of approximately three days. This is the length of time a farmer has to negotiate for their portion of the consumer dollar. Both the retailer and the processor know this, and use this natural imbalance of power to suppress the price of milk to a point that does not reflect the risk taken to produce the milk. The following diagram highlights the capital deployed per unit of milk along the supply chain in New Zealand, and is indicative of capital investment in other countries.

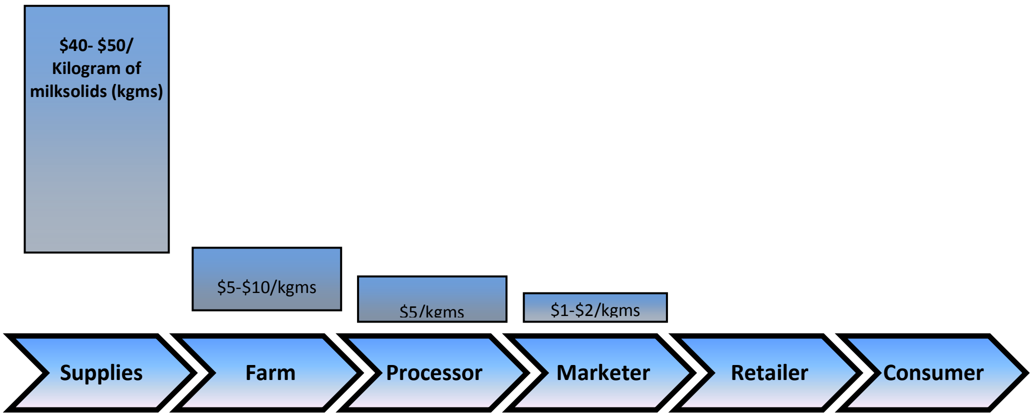

Figure 2: Capital deployed along the value chain per unit of milk

The capital requirement at farm level is high, with land, cows, milking machines and buildings. The value of the dairy farm unit is about five to ten times more capital intensive than the assets required to process the milk, and many times more capital intensive than the resources required to retail the milk to the consumer. Farmers invest together in downstream assets to move the negotiation point from when their product is perishable, to a point where they have more power. This is often at the processor level. Co-operatives capture a farmer's fair share of cash in the value chain.

The United Kingdom Example

The dairy industry in the United Kingdom provides an excellent example of the inherent inefficiency of the dairy value chain.

The past decade deregulation has seen ownership of the United Kingdom dairy processing assets removed from farmer co-operatives' hands and entrusted in dispersed public hands. The United Kingdom value chain was previously integrated through the Milk Marketing Board to the processor level. It was believed that deregulation would lower prices and benefit the consumer. As a result government broke up the processing assets and placed them directly into public hands. Farmers were able to market their raw milk together for a period through a body called Milk Marque. However this ability to even collectively market milk was also broken by parliamentary intervention in 2001.

The public have not enjoyed lower prices, despite the belief that breaking collective farmer ownership and milk pooling would lower prices to the consumer. Rather, the margin moved from the farmers, and has been captured by the retailers who are the strongest price negotiators in the value chain. This movement is depicted in Figure 4.

Figure4: Declining Milk Margins for UK Farmers[8]

During the time period from 1999 to 2010 the retailer has increased their nominal income by almost 300 percent and their share of the value chain by a massive 14½ percentage points. The impact of co-operative ownership upon the allocation of margin is highlighted even further by the startling fact that in 2010, New Zealand farmers were paid more for their milk than farmers in the United Kingdom[9]. This, despite selling less valuable products than that available to the farmer supplying the fresh milk market, and further, having to transport their commodity milk halfway around the world to find a market.

2.4 Co-operatives Maximise Cash into Farmer Hands and the Economy

The United Kingdom example highlights the lack of power farmers have without co-operative ownership or marketing milk pools at scale. These two key factors are the foundation of success that Fonterra dairy farmers enjoy in New Zealand. Without the collective strength of co-operative ownership the return to the farmer is squeezed. In the United Kingdom the collective strength of farmers was taken away by removing both ownership of processing assets, and the ability to market their product to the processors together at scale. Without ownership farmers no longer have representation at the negotiation table between the processor and the retailer, and cannot expect their interests to be served.

The removal of collective ownership and marketing encourages farmers to act individually. They are economically led to make short-term decisions for themselves, rather than for the whole industry and for the long-term. This individualist behaviour restores the inherent inefficiency in the dairy value chain, and results in a poorer financial return in the medium term. This decision of individualism versus a macro-view is similar to the proposition of contract milk in Fonterra. In the short-term contract milk is economically attractive for the individual. Supplying milk on contract can be more profitable because the capital investment in processing assets is not required. However, if all Fonterra farmers acted individually and supplied under contract, farmers would no longer own Fonterra. As demonstrated by the experience in the United Kingdom, the focus of the processor would likely shift, and maximising Milk Price would no longer be an objective.

Inefficient dairy markets are prevalent the world over. About 80 percent of the world's milk is marketed through co-operatives. Farmers invest together up the value chain to process their milk into a stable form. Once in a stable form the power imbalance is corrected, and farmers are able to capture a fair share of the consumer dollar to reflect the risk they take.

It is interesting to note that processor margins are also squeezed under different ownership structures. However, the consumer has not benefited from lower prices at the supermarket. What this means is that the margin shifts from the farmer and the processor to the marketer and the retailer.

In countries with a large domestic market this has little impact upon the GDP/per person as the entire value chain co-exists in the same economy. However, in New Zealand this phenomenon would have disastrous consequences. In our value chain the marketer and retailers reside abroad, the loss of margin for both farmers and processors would have a devastating impact upon our national economy.

Figure 5 shows the line where the value chain for New Zealand milk moves offshore. This is different from the United Kingdom where the entire value chain is within the domestic market.

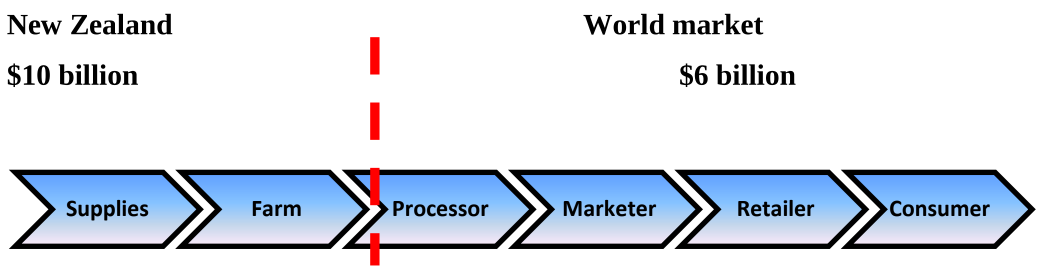

Figure5: Current Cash in NZ Dairy Value Chain

Figure 5 shows that of the $16 billion of annual revenues generated by the New Zealand dairy industry, currently $10 billion enter the New Zealand economy for re-circulation through our local communities. Figure 6 demonstrates the effect upon New Zealand if the co-operative ownership of its dairy industry was transferred into corporate ownership.

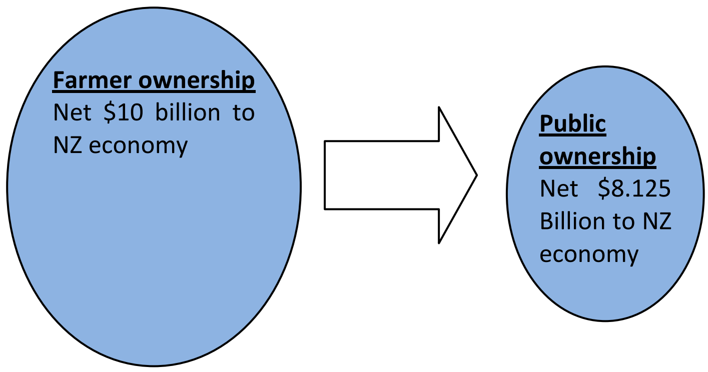

Figure 6: Potential Loss of NZ Net Income

If the trend displayed in the United Kingdom was observed in New Zealand the $10 billion of net cash that dairying actually draws into the nation would be reduced by almost $2 billion to just $8.125 billion. As demonstrated by the United Kingdom experience, the balance of almost $2 billion is absorbed by the marketer and the retailer.

For New Zealand milk these players reside off-shore, so the value they capture would be at the detriment of the New Zealand economy. Remembering that for every extra dollar dairy farmers earn $270 is created for the economy[10] the multiplier effect of such a reduction in our communities would be devastating. What it demonstrates is that contrary to popular assumption, introducing public equity into our core New Zealand dairy processing assets would actually substantially decrease the size of the pie, rather than grow the pie for Fonterra, Fonterra farmers and New Zealand.

Recovering $2 billion of lost revenue to New Zealand under a publicly-listed structure would take more than $20 billion of international assets and 100% New Zealand ownership.

This is assuming a 10 percent Return on Asset (RoA) with no debt funding. Leverage would further increase the total asset base required. For example 50 percent debt funding would require $40 billion of international assets at a 10 percent RoA to produce $2 billion for circulation in the New Zealand economy.

2.5 Conclusion

Co-operatives are simply large equity partnerships. They are often born where there is market inefficiency. Dairy is an inherently inefficient market because of the perishable nature of milk on the farm. Ownership in downstream assets is critical for dairy farmers to minimise the market inefficiency, so they gain a share of the consumer dollar that reflects the capital risk they take. Without co-operative ownership collective strength is removed. Dairy farmer margins are squeezed, and the cash is moved elsewhere in the value chain. If the experience of the United Kingdom were replicated in New Zealand this could mean a lower income for the nation of nearly $2 billion over time. Combined with the multiplier effect of that cash into local communities, this would be disastrous for the New Zealand economy.

3. Ownership Provides Purpose

Key Insights:

- **The owners of the business provide the purpose for the business**
- **If a co-operative is to grow farmers' benefit, farmers must own and continue to invest in the co-operative.**
- **Conflicting business purposes destroys value for farmers**

3.1 Introduction

This section discusses how the ownership influences the purpose of a business and how this behaves in a co-operative. It then discusses the impact public investment in a co-operative has upon the purpose.

3.2 Businesses Serve the Providers of Equity

The United Kingdom example from the previous section highlighted that changing the ownership of the processor margin changed the processor's focus away from farmers to its own small segment of the value chain. The processor stopped working to protect the farmers' margin, and unwittingly impacted upon their own portion of the value chain.

What this suggests is that ownership provides the company's raison d'être; its reason for being. Its purpose. Under co-operative farmer ownership the processor's role was to maximise the price back to the farmers. Now that the farmers do not own the United Kingdom processors, the processors have no interest in maximising returns to farmers. Their focus is simply on the profit line.

Businesses work for those who own the business. The person who owns the business is the person who provides the equity. The phenomenon demonstrated by United Kingdom processors is also replicated by the publicly listed processors in Ireland.

3.3 The Irish Model – Mixing Co-operatives and Public Equity

The Irish dairy industry underwent a revolution in the 1980's with a good number of dairy co-operatives incorporating public equity into their businesses. Most that have taken this pathway have languished, or failed, and have subsequently been acquired by other players. Two of the largest that remain are Kerry Group and Glanbia.

Kerry in particular has enjoyed spectacular success. Under the leadership of business visionary, Denis Brosnan, Kerry Group has grown at 15 percent compounding per annum since publicly listing in 1986[11]. It is now a global company with world leading competencies in the food ingredients market. Kerry has revenues of more than €4½ billion and assets totalling nearly the same. Its size is comparable to Fonterra, from a farming base the size of Taranaki.

Kerry farmers are rightly very proud of the success of their home grown company. Kerry is exceptional. Denis Brosnan is exceptional. However, Kerry Group is the exception, not the rule. Their stellar success is not replicated by the other co-operatives that trod the same path. Golden Vale was taken over by Kerry. DairyGold has hastily backtracked, saved by its strong co-operative balance sheet. Waterford was taken over by Avonmore, to form Glanbia, and at the end of 2009 had just 21 percent equity.

Despite their significant accomplishment, Kerry farmers, like Glanbia farmers are commonly paid in the bottom third of Irish dairy farmers. It is effectively the farmer-owned co-operatives that maintain the Milk Price for the farmers supplying the publicly listed creameries. Kerry farmers do have the compelling bonus of being able to purchase one highly valuable co-operative share per thousand litres supplied at the nominal value; however this right ceases in the near future.

One long-serving Kerry executive described the tension created in the business as:

"Riding two horses with one arse." - *Anonymous interviewee*

His graphical description highlights that it is extremely difficult to serve both farmer and investor interests. The tension is slowly growing, as throughout 2010 Kerry made noises in the media of further reducing farmer ownership in the company from its current 24 percent to maybe 10 percent. This is driven by the divide between supplying owners and investors, not just in Kerry Group, but in its farmer parent. Just under a quarter of Kerry Group is owned by Kerry Co-operative Creameries (KCC) which unites farmer ownership. However, less than half of the shareholders in KCC still supply milk, and each €1.25 nominal share in KCC is back by approximately €183 of Kerry Group shares and trades within the restricted farmer market at just €55-€65.

Despite Kerry's spectacular business success, it would seem today's generation of Kerry farmers are financially no better off than the farmers supplying DairyGold Co-operative. While only exploratory and by no means statistically proven, my Nuffield study compared the wealth creation achieved by farmers over a 20 year period. The indicative findings suggest that there was little discernable difference between the total wealth generated by either Kerry or DairyGold farmers during the past 20 years. This includes valuing the KCC shares at their full €183 value. However the findings do not take into consideration significant factors such as quality of land, and should only be read as a flag raiser.

In Glanbia the tension between investor and farmer goals has also amplified. Recognising this conflict, Glanbia farmers sought to take back control of their company in May 2010. They voted on returning Glanbia back to a 100 percent farmer-owned co-operative, achieving 73 percent support; just short of the 75% needed. It would not be surprising to see a vote re-put in the future.

The inclusion of public equity into a processor drastically changes the focus of the business, and it is common for intense tension to form between the farmers and the new public investors[12]. The goal of maximising Milk Price is replaced with the goal of maximising profit. The quickest way to increase profit is to *minimise* the Milk Price.

3.4 Outside Ownership Creates Intolerable Tension for Friesland

Friesland's experience with public investment is another example of public ownership working against the farmer. Before its merger with Campina, Friesland had allowed retired farmers to remain invested in the co-operative. The non-milking investors applied great pressure to increase the dividend at the expense of the Milk Price. This created such intolerable tension that Friesland farmers demanded the removal of public investment.

"You cannot be half pregnant. You either are a co-operative, or you are not. Your purpose is either to maximise Milk Price, or it is to maximise profit. It cannot be both." - *Anonymous interviewee*

3.5 Ownership Dictates the Purpose of the Business

Public investment changes the focus of the business from capturing a greater share of the consumer dollar for the farmer to simply maximising profit.

Consider this example. A dairy processor can increase the profit by $0.50c / share of the business by optimising milk flow through plant. This would enable the stainless steel to be utilised all year round at 95% of capacity. The plan would require dairy farmers to provide milk all year round at a constant level, and would increase farm working expenses by $1.50 per kilogram of milksolids (kgms).

- Which answer is in the best interest of the company when the business incorporates public investors?

o Which answer is in the best interest of the company when the business is 100% owned by supplying farmers?

o Which answer increases the profitability for the industry as a whole? (Assuming share capital relates to milksolids at one share per kgms)

This example demonstrates the change in decision making with the advent of investor ownership. Public investment into a dairy co-operative conflicts the business, as depicted in the figure below.

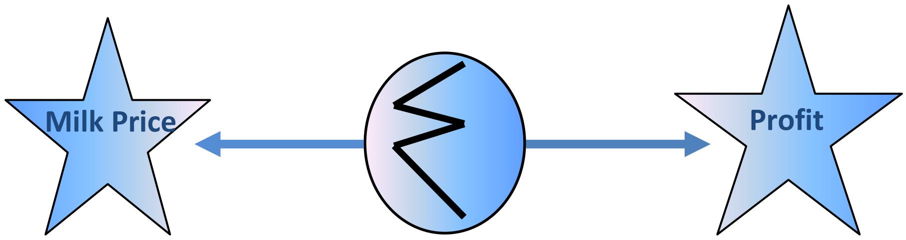

Figure 3: Opposing Purposes Conflict the Business

3.6 Conclusion

The ownership of a business provides the purpose for a business. It is farmers' ownership of their dairy co-operative that creates the business purpose to maximise Milk Price for farmers. The experience of Kerry Group, Glanbia and Friesland suggest that the integration of public investment into co-operatives changes the focus from Milk Price to profit. Their experience has shown that diluting farmer ownership lowers the Milk Price paid to farmers over time. The margin shifts from the farmer to the secondary processor and retailer, with very little being captured by the processor.

This lesson is important for the economic health of New Zealand. If this phenomenon is repeated in New Zealand then our nation will be significantly worse off. We may lose a significant portion of farmers' seven percent of GDP in our quest to grow GDP. We need to find a way of taking advantage of the opportunities facing the dairy industry, without putting the golden goose at risk.

4. Purpose Drives Strategy

"One day Alice came to a fork in the road and saw a Cheshire cat in a tree.

"Which road do I take?" she asked the cat.

"Where do you want to go?" was his response.

"I don't know," Alice answered.

"Then," said the cat, "it doesn't matter."

- Lewis Carroll in Alice in Wonderland, 1865

Key insights:

- **Purpose → Strategy → Structure** *Purpose is the destination. Strategy is a pathway. Structure is just a vehicle.*
- ***Know what you want to grow***
- ***Beware of the word "strategic."*** *Just because something is termed "strategic" does not make it strategic.*
- ***Ask "how does this increase my milk price?"*** *The answer should be simple.*
- ***In dairy co-operatives public investors do not have the same goals as farmer investor. Farmers invest to grow Milk Price. Public invest to Grow Profit***

4.1 Introduction

This section defines what strategy is and how it is set. It discusses the difference between strategic and non-strategic growth. It explores how growth outside of member's milk can be taken advantage of, and then discusses how co-operatives can grow Milk Price.

4.2 Strategy is a Pathway

In 1962 classical management theorist Alfred Chandler coined the saying, "Structure follows strategy"[13]. His simple insight into the deployment of strategy has shaped organisations throughout the world. Like an army at war, an organisation must determine its end-goal, select the best strategy to achieve that goal, and deploy its troops in a structure that enacts the strategy.

However, Chandler's clarity has been lost in time. We have come to use his adage to justify strategy, and this was never Chandler's intent. We have forgotten that strategy is not an end in itself. Strategy is a pathway that takes an organisation to a chosen destination – much like a roadmap. A map to Auckland will take you a very different place than a map to Invercargill. Without determining an organisation's purpose the Cheshire cat's message to Alice (above) rings true. If you don't know where you are going, any road will take you there. Together, Chandler and the Cheshire cat have a combined message:

Structure follows strategy and strategy follows purpose**.**

Purpose → Strategy → Structure

Dr. James Lockhart depicts the relationship clearly in this model below:

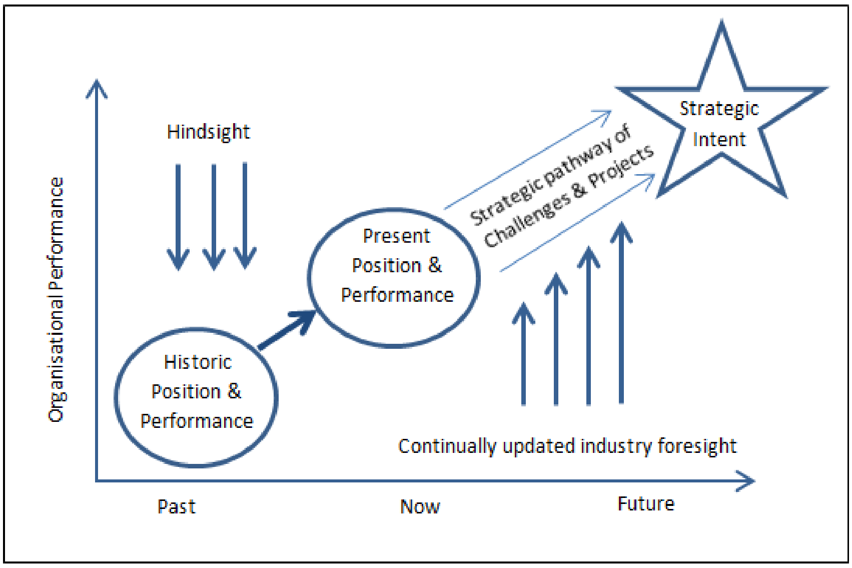

Figure8: Strategic Intent Creates the Strategic Pathway [14]

Purpose is the destination. Strategy is the pathway. Structure is a vehicle.

One of the themes repeated across the interviews was that too often things are labelled "strategic". The word is over used, calling things strategic that are not remotely strategic. It is too easy to say the words. And it is too easy to accept the words, but farmers need to probe deeper as owners of our co-operatives.

Ask,

"How is it strategic?"

The answer should be simple.

Ask,

"How does it maximise my Milk Price"

Strategy is simple. The answer should be simple, easy to understand and relate directly to the purpose. If the answer is complicated it is unlikely to be "strategic".

It is easy to be dazzled and sidelined by growth... especially when the words "strategic growth" and "strategic assets" are used. Take the often touted rhetoric: "If you aren't growing then you are going backwards". However, if growth is not strategically aligned to the purpose then the business will be conflicted.

4.3 Non Strategic Growth: The Example of DairyGold

An example of non-strategic growth is that of DairyGold in Ireland. In 2003 they hired charismatic leader Jerry Henchy from Kerry Group as their new Chief Executive. Henchy reorganised and rationalised the business, cutting staff numbers and closing plants, determined to bring efficiency to the co-operative. He was successful, driving cash back into the Milk Price.

Next, the Celtic tiger was roaring. The world was awash with opportunity. Henchy wanted to replicate the success of Kerry Group, and given his early results, the farmers followed him, afraid to miss out on the fortune to be made.

DairyGold held some of the most valuable brands in Ireland, and had significant landholding. In 2006 DairyGold divested their major assets into another company named Reox Holdings. This included their brands and land, including the land their factories sat upon. Shares in Reox were issued to famers and management, and Reox was listed onto the stock exchange. Milk Price became secondary; DairyGold farmers were investors now, and they were going to make their fortunes at selling home building supplies and become property tycoons.

When the bubble burst the lack of strategic foundation was evident. DairyGold's growth had not been in pursuit of its core purpose. Nor had they built upon the company's competencies. The stock value of Reox crashed and farmers removed Henchy from leadership.

DairyGold survived, thanks to a very strong balance sheet. However, there was a price. DairyGold had to sell their brand and their name, "DairyGold" to Kerry Group. This is shown in Figure 9 below.

Figure 9: DairyGold Butter Brand, Owned by Kerry Group

Today DairyGold is in the process of purchasing back the factory land from Reox; though it is doubtful that Kerry will give them back their name.

The lesson for farmers is to be wary of the words "growth" and "strategic". Instead, ask: "How does it maximise my Milk Price?"

When a company is successful it is very easy to see the myriad of opportunities available. There are a million and one opportunities that will grow the pure size of the business. However, in any business it is strategic growth, growth which delivers the company's purpose that should be pursued. Remember, strategy is just a pathway.

Sometimes, however, there are real opportunities that exist for a co-operative that are outside of the core purpose, but complementary to the business. Growth that takes advantage of core competencies can create real wealth. Are these opportunities to be forgone?

4.4 Can Co-operatives Grow Outside Member's Milk?

Growth beyond members' milk is a source of conflict in co-operatives. Professor Michael Cook from Missouri University researched this issue with Fonterra dairy farmers in New Zealand. He found the most tension between farmers that were growing versus farmers that were not growing.

The farmers that were growing wanted a simple co-operative that stayed inside the bounds of processing and marketing their milk. These farmers could often generate a higher return for their capital than the co-operative.

On the other hand, farmers that were not growing were keen to see their co-operative investment deepen, taking advantage of the opportunities open to the co-operative. They saw the co-operative as an investment co-operative.

The tension creates an issue. If there are real opportunities to the business, but some farmers do not wish to invest any further than core processing, then the co-operative and the investment focused farmers are stymied if there is a capital constraint. As previously discussed, introducing outside public investment into the co-operative would put the farmers' farms at risk.

Two interviewees, Professor Cook, and Dairy Farmers of America's Jay Waldvogel gave an answer to this question. Co-operatives can take advantage of discretionary opportunities that build upon core-competencies by ring fencing the core business, and growing the non-core high growth opportunities separately. Professor Cook termed the process "spawning"[15].

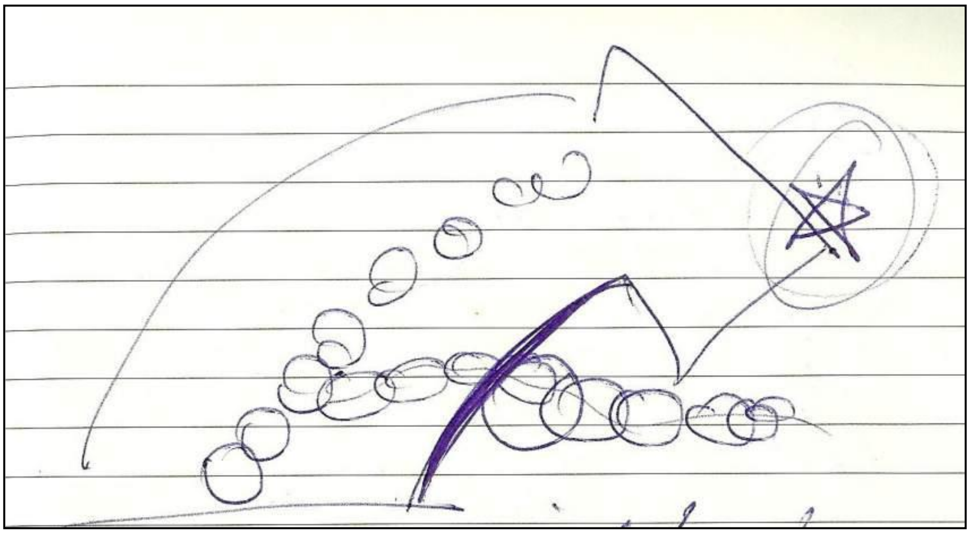

Figure10: Spinning off non-core opportunities by Jay Waldvogel

The figure above demonstrates this process. Once a discretionary opportunity is of such size that it requires additional investment then it can be spun-off outside of the core business, and offered for public investment. This possible strategy takes advantage of opportunities that build upon core competence while protecting the core profitability of the farmer. However, the opportunity can be less attractive to management, as it can effectively reduce the size of the business they are leading.

4.5 Growing Milk Price

Strategic thought leader Michael Porter tells us there are essentially two strategies: price leadership (commodity) or differentiation[16]. All that lies between is the valley of death, meaning if a business does not choose one or the other the business is destined to fail.

Figure11: Porter's Two Strategies

An example of a co-operative pursuing a strategy of differentiation is Tatua of New Zealand, or another is Parmagiano Reggiano of Italy (known as Parmesan when produced elsewhere). Farmers in this region of Italy gain a substantial premium for crafting this famous cheese from its historical home. Growth is up the value chain, and to keep the product differentiated and niche, farmer membership is restricted.

A commodity strategy is like that of Murray Goulburn Co-operative of Australia who exports milk powder to the world market. A commodity strategy is based on volume. Strength comes from widening the member base to:

(1) Match the negotiating power of the large multi-nationals that purchase from this market, and,

(2) Gain economies of scale in processing.

In New Zealand we have largely pursued a commodity strategy, and have achieved this strength by rationalising smaller co-operatives over several generations. This ultimately formed one major co-operative, Fonterra Co-operative Group, to deliver strength in negotiation and economies of scale.

Both Arla and FrieslandCampina provide example where co-operatives have continued to grow their member base beyond country borders, and thus increasing their bargaining influence with increased scale. FrieslandCampina has members in the Netherlands, Germany and Belgium. Arla has members in Sweden and Denmark. Arla has a separate semi-partnership with farmers in the United Kingdom, but generally appear to act more like a corporate in this market.

Porter's two core strategies of commodity or differentiation do not have defined places along the value chain. For example, it can be assumed that milk powder must take a price/commodity strategy. However, high quality, safe milk powder from free-range cows, living in the pristine environs of New Zealand can a differentiated product for which infant milk companies could potentially pay a premium.

A key lesson learned throughout the study is that you must know what you have. Our clean, green, pristine image and proven health benefits of grass-fed milk are two attributes we have potential to capitalise on as farmers, and provide real value to through our actions on farm. New Zealand Inc has value. We must protect it and harness what we have at our back door step.

Another management guru, Peter Drucker[17] reminds his students that the customer must come first. The customer is king. It is often hard for us to remember that on farm, but the way our product is produced is meaning more and more to the consumer. We can add value by bearing this in mind when we produce our milk.

4.6 Conclusion

Strategy is simply a pathway to a destination set by its owners. The core purpose of a dairy co-operative is to maximise Milk Price. The strategy to achieve this should be easily explained and relate directly to this purpose.

This section has discussed the differences in purpose between dairy farmers and public investors. The immense challenges in making these differing purposes co-exist are very difficult to overcome, even in the best examples.

Co-operatives can pursue opportunities outside of their core purpose if the core is protected, and ring fenced from outside investment.

5. People Create Results

Key insights:

- **Farmer directors must control the boardroom with a substantive majority**
- **If a leader conveys to you they are the messiah – they probably are not.**
- **Co-operatives must invest in a large pool of future farmer leaders to develop their directors 10 or 20 years ahead.**
- **Executive must know and be incentivised towards the farmers' purpose for investing in the co-operative**

5.1 Introduction

This section discusses how people are the key drivers of success in business. It discusses the critical role farmer directors play in governing the business, and highlights the importance that quality farmer governors must dominate the boardroom in numbers. It discusses how governance acumen must be developed in the shareholder base to ensure the success of the co-operative, and that politics must be rejected within the co-operative culture in selecting Board directors.

5.2 People Grow Businesses not Structures

Denis Brosnan grew Kerry Group from scratch into a multi-billion euro global food ingredients business inside 25 years. His mantra was 15 percent compounded growth per annum; meaning the business doubled in size every 4.8 years under his stewardship. Commonly commentators attribute Kerry's success to incorporating public equity. However, Irish dairies GoldenVale, Waterford and Avonmore similarly structured themselves, and in the same environment failed to enjoy the same results as Kerry Group. Kerry's success was driven by Brosnan and his team. Structure had very little to do with the success, it was the quality of the Kerry people that was key.

Denis Brosnan captured the hearts and minds of his people. He grew his people. His people drove results. A key element of Kerry's success is its ability to develop people. Kerry grows its leadership from within and even today, all bar one of the international heads of each Kerry business unit are Irish, and have been brought up through the grassroots of the business.

People grow businesses, not structures. This fact is well known, and documented in business literature. See Jim Collin's work *Good to Great*[18] for one popular example. Performance or ***growth*** comes from people who intimately understand and drive a business. Despite this, structure remains an expensive fascination in our co-operatives.

There are elements of structure that may be beneficial to our businesses, but structure alone can never deliver the success we invest for. Mostly, structure is a costly diversion to our valuable time. Success in business is 100 percent dependent upon the people who are driving the business. Skilled people can create success in a clumsy structure and a poor leader can drive a business to failure in a world class business structure.

How then do we ensure we have the right people in our businesses? From an ownership perspective, the culture to grow the right people must come from us through the boardroom.

5.3 Performance in the Boardroom

The quality of farmer directors is often questioned, with commentators challenging their lack of big-business experience[19]. Indeed, there have been some terrible failures and scandals in some co-operatives. The word "co-operative" in the United Kingdom for many means failure, due to politics and poor governance.

However, business failures and scandals are not peculiar to co-operatives. Serious failures such as Enron occurred even while complying with the structural requirements of widely accepted good governance standards and being led by some of the world's great businessmen. Enron demonstrates that governance failures occur without the help of farmer directors. In fact, the example of Dairy Farmers of Britain would strongly suggest that domination and the poor governance standards set by the high-profile *professional independent* directors led to the downfall of the co-operative[20].

Jim Collins puts forward that the best leaders are those that come up through the ranks of a business[1] as with Kerry. Home-grown leaders demonstrate a fundamental understanding and long-term commitment to the business which is rarely found amongst high profile charismatic leaders. While Collins was referring to senior executives, the same characteristic is likely to be true in the boardroom.

Farmers can make excellent directors and should dominate the boardroom. However, to be an excellent director, a farmer must be well trained, experienced and committed to the purpose of the business.

5.4 Develop a Large Pool of Potential Leaders

FrieslandCampina is an excellent example of developing high quality directors. They develop their farmer directors intensively and extensively using their "Potential Programme" which was inherited from Friesland. Young farmers are identified often in their early 20s, and then rigorously developed over time for senior governorship decades later. The result is a sharply focused, broadly experienced governor, fully prepared for the role while innately understanding the purpose of the co-operative.

The beauty of developing a large pool of potential governors is that even if an individual is never actually called to serve on the Board, the investment in them raises the standard of knowledge and quality of debate throughout the whole shareholder base.

The higher Boards or Councils used in FreislandCampina, Arla and Fonterra are an excellent and important breeding ground for directors where future Board directors can increase their knowledge, and test their skills alongside experienced governors.

5.5 Limit the number of Professional Directors

Good governance standards suggest that diverse and independent directors are important. Professional directors bring a healthy dynamic to the boardroom, offering another perspective. They are used to provide specialist knowledge and fill skill gaps.

However, farmers should dominate by a substantial margin, because they are critically aligned to the interests of the shareholders, whom the business serves[21]. Warren Buffet ensures he has a seat on the Board of companies he deems worthy of his cash[22]. Professional directors can bring big egos, especially to very large co-operatives. These egos can create a situation like the Dairy Farmers of Britain-styled Board. There, with a theoretically perfectly structured business, the motivations of the boardroom were poorly aligned to the needs of the farmers. In fact, Dairy Farmers of Britain was so poorly aligned to the member-owners that farmers were referred to as "natives" within the company. It is suggested that a ratio of at least 70 percent farmers to independent professionals would maintain farmer domination, and thus direction of the Board and co-operative.

5.6 Beware of the Charismatic Leader

Ego can be a problem in any business. It is easy for the charismatic leader to dominate, as their confidence is very attractive. There are plenty of leaders who believe they are the next Brosnan, as shown in the DairyGold example. There are a few out there of the calibre of Dennis Brosnan who built Kerry Group. The fact is that great singular leaders are rare. In their absence, the egotistical and self-absorbed that present themselves to be the next messiah can do serious damage to a business. If a leader tells you they are that special leader – they probably are not.

5.7 Removing Politics

Politics is a common and dangerous part of dairy co-operative governance, and can lead to failure. Politics discourages diversity of thought and can encourage a culture of rubber stamping.

Politics can be identified when:

(1) Parish politics," where farmers win seats on favours or patrimony, or,

(2) New governors are only elevated if asked by the domineering incumbent, and other candidates are portrayed to be poor choices regardless of their skill and experience, or,

(3) Discussion about the direction of the company is closed down with allegations of politics, or the commentator is labelled a "crack pot"

Farmer owners must root out politics from their co-operatives, and promote a meritocracy – or a culture of performance.

"Bullshit flourishes in the absence of clear measurement, clear policy and clear thinking."
- *Mike Murphy, Ireland*

A culture of performance is driven by rigorous measurement, and this is what discourages political behaviour. A lack of clear direction and lack of a performance culture creates a vacuum in which politics flourish. Farmers must actively:

(1) Vote and elect directors on merit, and

(2) Demand rigorous discussion and debate about the direction and performance of the business between governors and farmers.

5.8 Agency Cost: Incentivise Executive on Milk Price

It is important to incentivise management to ensure their drivers match those of farmer owners. This is the classical governance problem, stemming from the separation of ownership and control[23]. Adding to normal agency issues dairy co-operative success is measured by Milk Price, rather than simply profit.

It can be remarkably easy for management to forget this key reason for farmer investment, as I found first hand. During a co-operative leadership programme I attended abroad participants were broken out into industry groups. I was put into a group consisting of executives from three significant dairy co-operatives. We were asked to identify the core purpose farmers had established in the co-operatives we represented. There was significant debate to even list “maximise the price of milk for the farmer” as a core purpose. This was at a time where dairy farmers in that country were experiencing extreme financial hardship. During my farmer visits, Milk Price had been the first thing on every farmer’s lips.

This experience demonstrates how easy it is for management to forget the key purpose of the co-operative. Agency theory says that the interests of the farmer owners and management must to be aligned. The simplest and most effective way of doing this is to incentivise management on total Milk Price.

It can be argued that is not fair for management, as sometimes they may work very hard and Milk Price stays low. However, Milk Price is also low in that scenario for farmers. It would be odd to reward management when supplying shareholders are struggling. Further, other measures do not align owners and management, and can be manipulated. Consider the distorted behaviour that would emerge if you incentivise on profit for example.

Incentivising on Milk Price can be dismissed by rhetoric which says a co-operative has no influence on Milk Price. This is contrary to the whole purpose of farmers establishing and investing in their dairy co-operative. Unchallenged the rhetoric is dangerous. It becomes a self-fulfilling prophesy. It is like a student who believes they will fail the math test, and refuses to waste time studying, and consequently fails the math test.

If management believe they have no influence on Milk Price they will not attempt to influence negotiations and capture the farmers’ share. The rhetoric of “no influence on Milk Price” must be challenged by farmer directors. It is vital to the success of the business that the interests of the farmer owners and management are aligned via matched incentives.

5.9 Conclusion

Success is driven by people. Co-operatives must develop depth in their shareholder base so that they have strong farmer directors to lead the business. Co-operatives should seek to identify potential governors as young as possible, and rigorously develop the skills for leadership decades later.

Quality farmer directors are critical to co-operative success as they intimately understand the purpose of the business: to maximise Milk Price. Because of this farmer directors should dominate the boardroom in numbers. It is suggested that this margin should be by at least 70 percent. Professional directors are important, but should only be used to fill any skill gaps. It is important to be wary of charismatic leaders.

It is vital that politics are rejected within a co-operative, and a meritocracy promoted through open debate and questioning. Farmers must exercise their will by voting. Agency cost should be minimised incentivising management on Milk Price.

6. Feed Your Golden Goose

A man and his wife had the good fortune to possess a goose which laid a golden egg every day. Lucky though they were, they soon began to think they were not getting rich fast enough, and, imagining the bird must be made of gold inside, they decided to kill it. Then, they thought, they could obtain the whole store of precious metal at once; however, upon cutting the goose open, they found its innards to be like that of any other goose.

-Aesop, 6th Century A.D.

Key Insights:

- **If a co-operative is to grow for farmers, farmers must be prepared to invest and feed the co-operative**
- **Corollary is that farmers must be prepared to question and challenge the performance of the co-operative**

6.1 Introduction

This section discusses the importance of properly financing our dairy co-operatives and the ways farmers can make financial contributions. It briefly discusses the way capital can be structured, and discusses the appropriate level of equity a co-operative should maintain.

6.2 Caring For Our Critical Asset

For our co-operative to grow for us as supplying shareholders we must care for it. We must invest in it. If we don't invest the business will need outside investors. As previously discussed that will mean the business will stop growing for us. Our investment in the core co-operative may not return the same as we can achieve on farm. We may be able to buy another farm with that investment. However, if we do not invest in our downstream assets then our farms will stop returning proper margins. It is our ownership in the processing assets that protects our margins on farm.

6.3 Financial Structure

There are a million and one ways of structuring the capital of a co-operative. It must provide a stable base. Beyond that, the financial structure of the business is a side issue. There is no reason for farmer ownership to inhibit growth. The candy giant Mars is three times the size of Fonterra and remains 100 percent family owned.

Playing with structure takes away valuable time from growing the business, and diverts our attention from the numbers that really matter: the efficiency of the business.

Whether it is a fair value share, a market driven price, or a nominal share, it ultimately is of little consequence. 10 * $1 shares per unit, or 1* $10 share. These are debates which divert attention from the big issues. The appendices outline a range of different structures used throughout the dairy world.

6.4 *How Much Equity? How Much Debt?*

Many major dairy co-operatives sit around 30 to 40 percent equity as a ratio to total assets. This includes Fonterra who sat around 35 percent equity at July 2009.

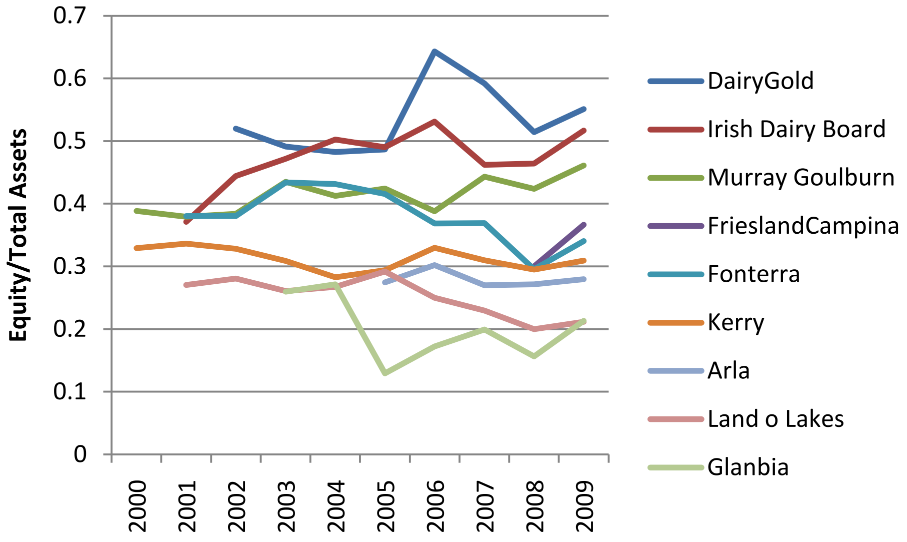

Figure12: Equity Ratios of Selected Dairy Companies

Co-operatives are able to gear more highly because effectively their operations are guaranteed by the farmers, via their outstanding milk cheques. This is known as subordination and means that should the co-operative be unable to pay its obligations as they fall due, farmers' milk payments will be diverted to creditors. Subordination allows co-operatives to gain higher international credit ratings, and either take on more debt, or pay less for debt at higher equity levels.

The question remains, is it prudent for a co-operative to leverage itself beyond levels generally accepted in conventional businesses? The New Zealand Institute of Directors offers the guideline that 50 percent equity is desirable in most businesses.

6.5 *Ways of Feeding the Business*

We, as supplying owners, have an obligation to feed our business through capital contribution. This may be through share capital up front, or through retentions. This obligation does not negate, however, our other duty as owners: to monitor and question our leaders as to their effective use of our money.

The other way we can feed our business is through deferred Milk Price payments. Most dairy farmers in the world are paid the full price for their milk the month following supply. Fonterra farmers are one of the few where our average time to be paid in full for our milk extends between 75 and 90 days. The first milk of the season takes a total of 446 days to be paid for in full in New Zealand, compared to a maximum of 51 days in many other dairy nations. This is a gift New Zealand farmers provide the co-operative. However, in providing this feed to our co-operative we must be vigilant as owners. This is not equity we are providing, it is lending. It costs us as farmers.

The longer any executive has spare capital, regardless of the business form, the more they view it as the company's capital, and start to dream different homes for it.

6.7 Conclusion

To continue to enjoy the fruits of our collective business we must be disciplined in re-investing into that business. We re-invest through the purchase of shares, through retentions, and by providing favourable payment terms for our milk. Our obligation to invest however goes hand-in-hand with our obligation to challenge. It is every farmer's duty to understand our collective business, and to question its performance. Every farmer has a duty as an owner to read their full co-operative annual report and all of the financial notes every year.

7. Conclusion & Recommendations

7.1 Introduction

This exploratory study sought to find how co-operatives grow for the farmers' benefit. The question is important to farmers and to the nation, as the fortunes of all New Zealanders go hand-in-hand with the fortunes of farmers.

The study explored the definition of a co-operative, and the situations where this structure is used. Co-operatives are a large equity partnership, where individuals with similar businesses invest up or down the value chain. They are often used where there is market inefficiency, such as is inherent in dairying.

This study has found that co-operatives grow for the benefit of the farmer through four themes: (1) Ownership Provides Purpose, (2) Purpose Drives Strategy, (3) People Create Results, and (4) Feed Your Golden Goose.

7.2 Ownership Provides Purpose

The owners of a business determine the purpose of a business. If a co-operative is to grow for the farmer, the farmers must own the co-operative. If farmers do not own the core processing *assets the focus of the business changes from growing the Milk Price for farmers, to maximising* profit. This would be damaging for the country, as the margin would flow to other players on the value chain outside of the country. If the experience of the United Kingdom was replicated in New Zealand it could potentially cost this country significant income.

7.3 Purpose Drives Strategy

For a co-operative to grow it must understand its purpose. Purpose is the destination. Strategy is a pathway. Structure is just a vehicle. The core purpose of a dairy co-operative is to maximise the price of milk. Farmers should ask their leaders how the strategy maximises their Milk Price.

Sometimes co-operatives are faced with opportunities to grow outside of their core value chain and access to public investment would be highly beneficial. In these situations the core processing assets should be ring fenced. These new high growth opportunities outside of New Zealand milk could incorporate public investment.

7.4 People Create Results

For a co-operative to grow farmers must invest in and develop their future governors. A large pool of future governors should be identified in their 20s, nurtured and developed to provide the future leaders. It is critical that high quality farmer governors are developed and must dominate the Board by at least 70 percent. Politics must be rejected in dairy co-operatives, and a meritocracy grown. Farmer owners have a duty to exercise their control through their vote. Executive must understand the purpose of the co-operative, and must be incentivised towards that goal.

7.5 Feed Your Golden Goose

Farmers must continue to invest in their co-operatives for them to grow. This investment may be through purchasing share capital, through retentions, and via deferred payment for their milk. The obligation to invest requires that farmers rigorously question the Board and understand the performance of the business.

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