

DAIRY COMPANIES, CO-OPERATIVES AND TRANSVESTITES

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There are three types of business structure in dairy processing and marketing:

- investor oriented companies (hereafter called IOFs),
- co-operative companies, and
- a range of structures that are not quite one thing or the other.

Hence the title for this address.

With IOF companies it is usually clear what they are. Currently there are three significant New Zealand dairy companies that fit in this category. They are Open Country, which operates in both the North and South Islands, plus Synlait and New Zealand Dairies in the South Island. Their aim is to make profits for their owners. They pay as much for their milk as they need to pay so as to get supply. And they pay no more than this and never will. We will probably see more of these companies setting up in the future, probably with either part or total foreign ownership. Their success will depend on their efficiency. If they can't afford to pay enough to get sufficient supply then they will fail. If they are more efficient than competitors they will make very nice profits.

From a farmer perspective there is nothing wrong with an industry dominated by IOFs as long as there is lots of competition. This is the case in some but not all parts of Australia. In parts of Victoria, companies compete with each other and prices get driven up to a level such that the IOFs make only modest profits. When farmers dislike the price their company is paying, then they very quickly move to other companies. But where there is no competition then farmers are indeed at the mercy of their processor. The concept of 'fairness' has no relevance. It is all about supply, demand, and competition. Fonterra itself acts in Australia as an IOF.

Twenty years ago it was very clear what a dairy co-operative was. It was a business structure owned by its suppliers who provided what was known as service capital, and they did this in proportion to their milk supply. Typically much of this capital came from retentions from payout. These retentions then gave 'freeboard' for borrowing. A key characteristic of these co-operatives was that all members' interests were aligned: what was good for one member was also good for all; and if something was bad for one then it would also be bad for all. Westland Dairy Co-operative still fits broadly within this traditional framework, but Tatua and Fonterra have both moved on.

Tatua is a special case in that it is a closed co-operative; i.e. it does not accept new members unless they purchase the farm of an existing member. Tatua is a very interesting co-operative and by most criteria highly successful, but lessons to be learned from studying its capital structure are not readily applied elsewhere in the industry. So it will not be considered further here. (However, if a group of farmers were ever to consider setting up a new and small co-operative, then Tatua would be a good model to look at, both for structure and strategy.)

Fonterra has been different than a traditional co-operative since formation in 2001. It has provided capital gain on shares (and also capital losses). It has made minimal retentions from the payout. It has also been very highly leveraged: as of the 2009 balance sheet, there was almost \$2 of liabilities for every \$1 of equity. (The previous year the leverage was even higher). It has been structured for fair weather sailing, and the global downturn has caused stress. However, at least until 2009, it is clear that Fonterra was still a genuine co-operative. This was because almost all suppliers were supplying capital in proportion to their production. As a consequence, all members' interests were broadly aligned.

As of late 2009, it has been possible for Fonterra's farmer suppliers to purchase dry shares as an investment. This was a step, albeit a small step, away from a fundamental principle of co-ops that all members should be aligned. If the current proposals for share trading are implemented then this will represent a much bigger step away from mutual alignment. Some members will be receiving dividends on twice the number of their production shares. And other suppliers will receive no distributable profits. Accordingly, some members' interests will be best served by a high distributable profit whereas others will want to see the milk price maximised. This has potential to become a source of friction. If there were a genuine market price for milk this would not be an issue. But Fonterra is so dominant that there is no genuine milk price. The division between milk price and profit will be determined by accounting and financial formulae. Accordingly, there is a need for these formulae to be fixed and transparent. That is not fully the case at present, with the details being buried within a confidential milk pricing manual, which can presumably be changed at any time.

Redemption risk exists in all co-operatives but to varying degrees. It arises because departing members are usually entitled to be paid their capital contributions. This is not a problem if new members are also coming into the co-operative, but is a problem if membership is declining. Traditional co-operatives minimise this risk by not providing capital gain, and retained profits thereby become unallocated reserves, which are a form of fixed capital. Co-operatives such as Fonterra, which allow capital gain, and do not hold unallocated reserves, are particularly vulnerable. Fonterra's current proposals, despite some claims to the contrary, do not eliminate the redemption risk from declining supply. A scenario that needs to be considered is what would happen if Fonterra were to lose say 10% or 15% of its supply to other companies.

Currently it is impossible to say what the effect of this would be because Fonterra has not spelled out how it intends to manage the proposed overall cap of 20% of investment shares. If Fonterra allocates all of these shares while times are good, then it will bring in about \$1 billion of extra capital. But then it will have no further flexibility if it loses supply. And so Fonterra would, by its constitution, have to redeem shares to come back within the limit. Alternatively, if Fonterra does not sell all of the 20% of investment shares, then it will not gain the same level of additional capital. In that case, it would be able to stay out of the share market if it lost some supply, although what would then happen to the price of the shares would be an open question.

So this brings us to another key issue, and that is the whole issue of a co-operative that trades in its shares. It is an issue that needs careful thought, because it does take Fonterra quite some distance from co-operative principles. However, this market will be quite different to most markets. The price of shares will be determined by how Fonterra plays the market game. For example, if Fonterra sells shares into the market so as to maintain the total number of shares at 20% greater than production shares, then the rules will be clear and investors can act accordingly. But Fonterra has indicated that it will retain flexibility in the interests of shareholders as to when and how it supports the market. But whoops! In this new world the interests of all members will not be aligned. Some will want a high share price and others will want a low price. So which members will it act in the interests of?

What this all means is that Fonterra would be moving into territory where, although still called a co-operative, in reality it would definitely not be quite one thing or the other. There is nothing necessarily wrong with such a status. And there are merits from being broad minded about these things. But it can lead to confusion, and there can be unintended consequences. It has elements of a journey into the unknown, with the eventual destination unclear.

It is also worth reflecting how quickly proposals can change. In late November the concept was for individual farmers to be able to hold a maximum of 20% of investment shares. Now, a few months later, the proposal is that it can be 100%. Will there in the future be a suggestion that the overall cap might lift to say 100% with individual farmers at say 500%? And where will that journey end?

None of the above should be interpreted as a reason why farmers should necessarily vote against the Fonterra proposals. But whatever they do, they need to do so with their eyes open.

So what would happen if Fonterra members were to vote against the Stage 3 (tradability) proposals? Are there other alternatives that retain farmers' fundamental requirement of farmer control? Well yes there are. Increased retentions are one possibility. But that option is somewhat messy because of the Stage 1 and 2 proposals that farmers agreed to in late 2009. Now that share capital is no longer totally aligned with production, then it would be unfair for retentions to come from the milk price. It should only come from distributable profits.

Also, although increased retentions will help Fonterra's balance sheet, at least in the short term, it will not necessarily reduce the long term redemption risk, unless these retentions are held as unallocated reserves, rather than as individual farmer capital. In fact, regardless of what happens with Stage 3, there is a strong argument for more retentions from what is now called distributable profit. Retentions from distributable profits are a fundamental necessity.

An alternative and very different strategy would be for Fonterra co-operative to retain all processing facilities, including ingredients, under co-operative ownership and control, but allow consumer activities to be spun off as IOFs, with, at least initially a cornerstone shareholding by Fonterra co-operative. Apparently this has never appealed to Fonterra management, but it is an option that could be structured to meet farmers' needs.

Whatever direction Fonterra members decide to take their co-operative, there are no 'free capital' solutions. If Fonterra members want to have both control and growth, then they will have to provide capital. So moving away from the concept that all members must provide their share of capital, either 'up front' or through retentions is a big step. It won't be easy to reverse.

This presentation was written in mid May, 2010. The version to be presented and discussed at SIDE 2010 will incorporate any subsequent modifications to the Fonterra Stage 3 proposals