NEW ZEALAND

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FARMING SCHOLARSHIP

TRUST

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1998 Scholar

Deregulation in the UK

Corporates vs Co-operatives in the Dairy Industry

Animal Welfare, Food Safety and Environmental Issues

A Study Tour of Europe and North America

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Table of Contents

Introduction

1. Background

1.1 I am a farm accountant employed as a Manager in the New Plymouth office of Ernst and Young, where I specialise in financial advice and business planning for the rural sector, predominantly dairy farming.

1.2 Together with my husband, we also own and operate a 39 hectare dairy farm at Ratapiko in Central Taranaki. The property is of hilly terrain and has a Giant Buttercup problem, but after 6 years of 50/50 sharemilking, it offered us the opportunity to achieve farm ownership, which had been our goal when we began farming 8 years earlier.

1.3 At the time I was awarded the scholarship, we were milking 110 cows. However, since returning from my trip we have seized the opportunity to increase the size of our operation by purchasing a 32 hectare adjoining property and from 1 June 1999, we will be milking 190-200 cows on a total of 78 hectares. (We also lease 7 hectares).

2. Area of Study

2.1 At the time I applied for the scholarship, the debate over deregulation of the dairy industry in New Zealand was gaining momentum. In particular, politicians charged with the responsibility for the agricultural portfolios were very vocal in their support of the benefits to be gained by deregulating the producer boards and more significantly, by removing the statutory single desk seller legislation that currently supports the operations of the New Zealand Dairy Board.

2.2 Furthermore, the Business Roundtable was scathing in it's criticism of the Dairy Board's performance to date, suggesting that this performance could only be improved if the industry was opened up to outside investment.

2.3 I therefore decided the Nuffield Scholarship would provide the ideal opportunity to see how dairy farmers in other parts of the world were surviving under alternative ownership structures and also to see what other issues are impacting upon their returns.

2.4 To this end, my topic of study became:

- *deregulation*
- *corporate vs co-operative dairy companies*
- *animal welfare, food safety and environmental issues currently influencing farming practices around the world.*

Executive Summary

1. Deregulation of the UK Dairy Industry

1.1 The Milk Marketing Board in the UK was deregulated in 1994 and the previously integrated dairy industry was fragmented into separate organisations responsible for milk collection and dairy processing.

1.2 This opened the door for true competition for dairy farmers who could now choose to supply milk directly to any one of a number of independent processors, many of whom are public listed companies.

1.3 Competition for milk supply initially saw milk prices rise 15%. But after four years, the milk price has dropped some 30%. The farmer owned supply co-op (Milk Marque) has lost 24% of it's market share as more and more farmers are attracted to the independents who pay a slightly higher milk price.

1.4 Milk Marque finds itself in the extraordinary position of not only selling the bulk of it's milk to it's competitors, but also sets the base price above which it's competitors pay a premium to attract direct milk supply from farmers.

1.5 Because Milk Marque has no processing capacity of it's own, it must onsell all it's milk to the independent processors. Until it can rebuild a processing capacity of it's own, it will always pay the lowest milk price. This rebuilding phase takes a lot of time and capital and will require the development of new brands and markets. This demand for funds puts even greater pressure on milk price.

1.6 All farmers appear to be worse off under this new deregulated environment. The independent processors seem able to manipulate the purchasing system so that the milk price paid to farmers is an absolute minimum. Dividends is the key measure of their performance and can only be maximised if costs (including the cost of milk) are minimised.

1.7 Competition seems to have been more destructive than constructive and the farmer owned co-op is now desperately trying to rebuild an integrated "cow to customer" structure in order to regain some ability to influence returns to farmers.

2. Corporates vs Co-operatives

2.1 **Corporates**
There are a number of corporate dairy companies operating in Ireland, with varying degrees of success. The most successful of these would be the Kerry Group ***plc*** and the Avonmore Waterford Group ***plc.***

2.2 There is no doubt that Kerry has been very successful since it adopted the aggressive growth strategy in 1986 and became a ***plc*** (public listed company). Turnover has increased from NZ$570 million in 1984 to NZ$4 billion in 1997. The shares, initially issued to farmers at 35 pence, were trading on the Stock Exchange for 11 pound each in April 1998.

2.3 The farmers involved in the company at these early stages are very proud of this achievement. Their investment in the industry has been "unlocked" and can be cashed in at any time at true market value. Their income is now derived from three sources – milk price, dividend flow and capital growth in share values.

2.4 But not all the corporates have been as successful. Waterford narrowly avoided financial ruin by merging with Avonmore in January 1998. Golden Vale is under constant pressure, from both shareholders and farmers, to improve it's very mediocre performance.

2.5 Furthemore, many of the younger farmers are feeling uncertain about their future. They cannot afford to pay the high price for Kerry shares. Their income stream is limited to milk price. Farmer ownership of the company is now significantly less than 50%. As the Kerry business, has grown the dairying sector has become the smallest and least profitable division. There was talk that if the company was forced to rationalise, the dairy division may be sold off. These farmers were worried that as shareholders demanded higher dividends, their milk price would be lowered……and lowered….and lowered. They could become peasant farmers once again.

2.6 **Co-operatives**

On the other hand, there are several 100% farmer owned co-operatives throughout Europe and the USA who are achieving the same levels of success, in terms of business growth, without having to raise capital on the Stock Exchange.

2.7 Friesland Coberco in Holland has a turnover of NZ$8.5 billion, operates throughout the world and has established a system of farmer tradable shares that not only "unlock" the value of a farmer's investment in the industry, but also identifies a performance measure other than payout.

2.8 MD Foods in Denmark is a true 100% farmer owned co-op. They have no shares. Farmers join for nothing and leave with nothing. They pay the highest milk price in Europe, operate on a 25% Equity ratio and have a global turnover of $NZ6 billion.

2.9 Land O' Lakes and Dairy Farmers of America are also huge farmer owned co-operatives that have developed a system of patronage shareholding. This system enables the company to retain profits for growth, but recognises each suppliers contribution to that growth, so he can eventually cash it in when he retires.

2.10 All these companies had identified strategies for global growth and were actively merging with and acquiring other complimentary businesses to help them build critical mass. They all recognise that size is power.

2.11 It seems therefore, that it is not necessarily structure that dictates the success or otherwise of a company, but more the vision, skills and ability of the leaders and the management to define and implement a strategy to achieve the desired goals of the owners of the company.

3. Future Issues

3.1 **CAP Reform**

The European Union is talking of reforming the Common Agriculture Policy over the next 6 years. However, direct production subsidies will simply be replaced by more environmentally and socially based subsidies aimed at keeping farmers on the land.

3.2 Quotas are expected to be abolished by 2006, but this in itself may see an <u>increase</u> in milk production over the short term that could seriously impact on New Zealand farmers. I see little or no prospect of improved returns for New Zealand farmers as a result of these proposed reforms. The political animal called CAP is an unreliable and unpredictable beast.

3.3 The New Zealand Dairy Board

The NZDB is very highly regarded for it's performance throughout Europe and the USA. Many of our competitors openly admit they do not like meeting them in the market place. They are all waiting, and hoping, that deregulation in New Zealand will see the demise of their toughest competitor.

3.4 **Power of the Supermarkets**

Supermarkets wield an incredible amount of power in the food retail sector. This power is such that they can significantly influence returns received by food producers, either through demanding

exorbitant payments for “shelf space” and/or through their “own brand” products which are regarded as premium quality products by the consumer.

3.5 They demand very high standards from their suppliers, not only in product quality but also immediate on- demand availability. There is little or no loyalty. If a supplier can’t supply on demand, someone else will.

3.6 Consumers are increasingly concerned about food safety, animal welfare and environmental issues. Recognising this, supermarkets are demanding that more and more products they sell are supported by full quality assurance and traceability programs. But price will always be the single most important determinant. If the price isn’t right, it won’t be sold.

3.7 **Animal Welfare**

While animal welfare is largely about perception, the New Zealand dairy industry receives a lot of criticism in Europe for some of our farming practices. Tail docking, inductions, dehorning calves, winter strip grazing, lack of shelter, walking distances, disposal of dead stock and transportation of in-calf cows are all mentioned as areas where our practices would be considered unacceptable by the consumer.

3.8 It is important, if we want to continue to protect our business from unwanted media attention and perhaps consequential loss of markets, that we do much more to make some of these practices more acceptable (or less visible) to the public. Education of the consumer and the supermarket buyer is part of the answer but farmers must be willing to change as well.

3.9 **Scale**

It is very evident after travelling through Europe and the USA that all sections of the dairy industry recognise that scale of operation is an important key to future profits. ***Size is power,*** not only at the processing and marketing level, but also at the producer level. Growth by acquisition and merger was evident at all levels and the New Zealand industry is no different in this respect. Our future too will depend upon our ability to continue to grow our business, to remain competitive in the global market place.

Part 1 – Deregulation of the Dairy Industry in the UK

1. Background

1.1 There are approximately 234,000 farmers in the UK where average farm size is 52 hectares. The number of farmers is, however, decreasing as farms are amalgamated and the demand for land for urban and industrial uses increases.

1.2 Approximately 55% of farming units are full-time operations, although an increasing number of farmers have sources of non-farming income.

1.3 Many units involve multiple enterprises (eg dairying, cropping and beef farming). This reflects the historic desire of farmers to protect themselves against volatile returns within each sector, by diversification. It is also a trend that has been reinforced by the quota and subsidy policies available under CAP (the Common Agricultural Policy of the European Union) for the various land uses.

1.4 As at June 1996, the number of units that included dairy cows totalled 37,700 or 17% of all farming units but by 1997, this had already dropped to 33,500.

1.5 There are approximately 2.5 million dairy cows in the UK where the average herd size is 75, although 7,900 herds have more than 100 cows. These animals make up 46% of the national herd, which is predominantly Holstein Friesian.

1.6 Of all the milk that is produced, approximately 55% is consumed on the domestic market as liquid milk. Per capita consumption of milk is amongst the highest in the world. The population of the UK is 58 million, so this accounts for a lot of milk!

1.7 The dairy industry is supported by several organisations, many of which have been corporatised to some degree or other. The most significant of these include:

- *Milk Marque:* a supplier's co-op that collects the majority of milk from producers and onsells it to independent processors

- *Genus:* a farmer/employee owned company responsible for developing new cattle breeding technologies, marketing frozen semen and providing the UK's only nationwide AI service

- *Axient:* the consultancy and advisory arm of Genus, providing services that include farm business accounts and tax, planning and monitoring, nutritional advice, equipment and machine monitoring, as well as advice on building development and design, effluent and waste disposal, animal welfare and hygiene

- *NMR:* National Milk Records encompasses milk testing and recording, herd records and event recording, software services as well as financial data, statistics and advice

- *ADC* Animal Data Centre provides data for animal evaluation and performance indices

All of these organisations arose out of the ashes of the old Milk Marketing Board, which ceased to exist as a result of the deregulation of the dairy industry in November 1994.

- *ADAS* is another significant organisation providing research, consultancy and laboratory services to the agricultural sector. Until 1997, this was a government agency, but was recently privatised when the majority of the business was sold as part of a management/employee Buyout.

There are several other research organisations such as Cirencester Royal Agricultural College, Moredun Research Institute, Scottish Agricultural College.

1.2 The Milk Marketing Board

1.2.1 During the 1930s, due to the difficulties that farmers were experiencing trying to sell their milk the Milk Marketing Board was established. Legislation required that all milk produced must be sold to the MMB who were then responsible for onselling that milk to private processors.

1.2.2 The farmers favoured this arrangement as the problem of finding a market for their product was no longer their individual responsibility. There was also a guaranteed sale for all the milk they could produce and they got paid a pooled price on a regular basis, regardless of what their milk was processed into.

1.2.3 Progressively, the MMB also began developing it's own breeding and production programs, an advisory service and it also developed its own processing capacity under the brand name of Dairy Crest. The industry was developing a vertically integrated structure.

1.2.4 Because of the role of the MMB, farmers became more and more protected and isolated from the marketplace.

1.2.5 In 1974, the UK joined the EEC and found that the European Commission didn't support the philosophy of a Milk Marketing Board. The European Commission required that the milk price had to be established by agreement between the MMB who represented the producers, and the Dairy Trade Federation who represented the processors. Most of the processors are *plcs* (public listed companies). If a milk price couldn't be agreed upon, then the matter went to arbitration.

1.2.6 This effectively guaranteed a margin for processors and therefore stifled any inclination towards adding value or innovation. Over time, this arrangement became very "comfortable" for all those charged with agreeing the milk price and resulted in farmers getting the lowest price for milk ever.

1.2.7 In 1984, Milk Quotas were introduced whereby the amount of milk a farmer could produce was limited to 20% less than previous production levels. Any production above their quota incurred a severe penalty. The objective was to arrest growing surpluses within the European Community.

1.2.8 The more progressive farmers were now highly restricted and frustrated by their inability to expand and grow their business. Some farmers chose to buy or lease quota in order to increase their capacity to produce milk but this added to their cost structure.

1.2.9 This combination of frustration at restricted outputs, low milk prices and a MMB that was seen as becoming more and more bureaucratic, resulted in declining farmer support for the MMB. Farmers believed that the MMB was undertaking too much for the "good of the industry" rather than for purely commercial reasons and that all this was limiting their profitability.

1.3 Deregulation and The Creation of Milk Marque

1.3.1 With this background, the UK government, under Mrs Thatcher, deregulated the dairy industry from 1 November 1994. They argued that this producer board had become ineffective because:

- it was not market responsive
- it was anti-competitive
- it stifled innovation
- it did not generate enough capital investment

1.3.2 The MMB was dissolved and Milk Marque was created as a voluntary suppliers' co-operative. Producers could now choose not to sell their milk to the Board, but directly to independent processors or a marketing group of their choice.

1.3.3 At this time, Milk Marque had approximately 55% of the milk supply throughout England and Wales. Just as the old MMB had done, they onsold this milk to independent processors on behalf of their supplier members.

1.3.4 However, in England a monopoly is regarded as anything that controls more than 25% of an industry. This meant the competition authorities were not comfortable with Milk Marque's position in the market place.

1.4 The First Mistake

1.4.1 In order to satisfy these authorities, the government required that Milk Marque divest itself of its processing arm, Dairy Crest. This company had the ability to process up to 20% of the dairy processing market.

1.4.2 At the same time, the other business activities previously undertaken by the MMB, such as the breeding program, advisory services and milk recording services were separated out to be set up as stand alone business entities.

1.4.3 Milk Marque became purely a milk supply co-operative, collecting milk from its members and onselling to independent companies for further processing.

1.4.4 These independent processors were obviously not disappointed by this move. Now, they had a guaranteed source of milk, a highly perishable product, from a supplier that had no choice but to sell to them as they were unable to process any of that milk themselves.

1.4.5 Furthermore, the government required that 90% of the milk had to be sold under a tendering system. If an agreed price could not be reached for 90% of the milk, then ALL the milk had to be re-offered for tender.

1.4.6 While up to 300 customers throughout England and Wales tender for this milk, the majority is purchased by 6 large processors who dominate the market. It is therefore not surprising that the milk price negotiations in January 1998 took four attempts before an agreed price for that 90% was reached. It is also not surprising that the final average tender price was little more than the EU Intervention Milk Price Equivalent. (This is effectively a guaranteed minimum price.)

1.5 Competition

1.5.1 With deregulation, came competition. Farmers could chose to supply their milk directly to independent processors.

1.5.2 These processors decided to lure farmers by offering to buy their milk at a premium of up to 2 pence per litre above the price offered by Milk Marque.

1.5.3 This initial scramble between independent processors to secure milk supply, not only directly from farmers but also from Milk Marque, saw milk price rise by approximately 15%.

1.5.4 However, only 55% of farmers chose to continue to supply Milk Marque. The premiums offered by the independent processors were too attractive and by 1998, this share had fallen to 42%.

1.5.5 All the original shareholders in Milk Marque were issued Certificates Of Entitlement that represented the value of their investment in the co-operative. Those shareholders that chose to leave had to be "paid out" within 29 months, out of retained profits. Most of those shareholders that chose to stay had their Certificates converted to preference shares, thus securing some equity in the co-ops Balance Sheet.

1.5.6 Even so, Milk Marque has found itself in the extraordinary position of:

- setting the base milk price for it's competitors
- selling the majority of it's milk to it's competitors
- losing market share because it's milk price is the lowest (and always will be)
- having to refund "deserting" shareholders out of retained profits, thereby further reducing available payout to loyal suppliers
- having no other market options until it can rebuild processing capacity of it's own

1.6 The Milk Price

1.6.1 As the independent processors have been able to secure the supply of milk from the better farms (the cream of the crop), the premium above Milk Marque's price has dropped. Also, as the tendering system has evolved, the price paid to Milk Marque by the independent processors has also dropped. The net result is that the average milk price has dropped some 30% over the last 18 months.

1.6.2 Given that the main objective of these companies is to maximise profits and dividend flow to shareholders – not milk price to suppliers – this is not an unpredictable outcome.

1.6.3 By the time I left England in June, many farmers were facing the prospect of a milk price equivalent to 18 pence per litre when 12 months earlier they had been getting 25-28 pence per litre. For many of them, this new price would barely cover their cost of production.

1.6.4 Not all of this price reduction was due to the effects of deregulation. Approximately half of the price drop is estimated to be due to the strength of the English pound relative to that of other European currencies. This currency issue meant that many processors could import product from other European countries cheaper than they could buy and process English milk, unless the price came down. Also, the value of exports sold was declining in order to compete on the international market place with exports from these other countries.

1.6.5 Needless to say, many farmers are very angry at their predicament. Some are taking the opportunity to either sell or lease their quota, their land and their stock and find they are better off than they ever were before.

1.6.6 Others are very vocal in their quest to convince retailers and consumers to "Buy British". I met some dairy farmers at a Nuffield meeting in York who were adamant that New Zealand should no longer have the privileged access to European Butter markets that it has enjoyed up to now. They strongly believe that it is now 25 years since England joined the EEC, they no longer owe us anything and that besides all that, our "product quality and animal welfare standards were far inferior" to those under which English product was produced. The vehemence with which they expressed these opinions was startling.

1.7 What Next? – The Full Circle

1.7.1 However, rebuilding a processing capacity all takes time and capital. Also, it means that Milk Marque will have to develop new markets and Brands for its products.

1.7.2 The supplier co-operative will have gone full circle in a bid to gain more control over its ability to maximise returns for its members.

1.7.3 Some farmers who have previously left the co-operative in exchange for higher returns from independent processors are now regretting their decision. These independent processors are demanding increasingly higher standards of milk quality and control, adding significant costs to the producer.

1.7.4 Some of these demands add no value to the milk. For example, I met some farmers whose company required that they maintain planter boxes and/or gardens outside the farm dairy so that the area looked "pretty" for the Supermarket buyer when they wanted to visit the farms from which the milk was sourced.

1.7.5 Many of these quality control systems were time consuming to record and administer. Not only did they require evidence of milk quality and hygiene, but also strict records of vet treatments, drugs used and stored, stock movements and animal event histories.

1.7.6 The premium above the Milk Marque price was almost non-existent. Supply contracts with these independent processors were short term, perhaps only 12 months or even less, meaning the farmer had no secure market for his milk.

1.7.7 They also had no say in the management of the company as they had no ownership.

1.7.8 A few farmers were wanting to return to Milk Marque, but even to do that, they were having to "buy back" their right to supply and as Milk Marque's position strengthens, the entry price will increase accordingly.

1.8 Monopolies and Mergers Commission

1.8.1 The whole process of buying and selling milk in Britain is currently under investigation by the Monopolies and Mergers Commission.

1.8.2 This investigation was precipitated by Milk Marque buying the first cheese plant in Wales. The independent processing plants are strongly opposed to this move and have complained that Milk Marque is trying to manipulate the market.

1.8.3 However, the investigation is expected to encompass a review of the whole system from pricing and supply, to controls and regulations as well as the attitudes of suppliers and the overall bidding process.

1.8.4 It is expected that a report will be available early in 1999 so it will be interesting to read what changes, if any, they recommend to the present system and structure.

1.9 Has Deregulation Been Successful?

1.9.1 It would appear to me that the initial objectives of deregulation in the UK have not achieved the desired results.

1.9.2 Certainly, there is now more competition for milk supply and initially this provided some increase in milk price. It has also resulted in the removal of some of the bureaucracy in the management of these organisations, as they attempt to become more profit driven.

1.9.3 But overall, it would appear that this competition has been more destructive than constructive. It has fragmented the industry as farmers have deserted their position of strength through unity, in exchange for promised higher returns, short term as they have been.

1.9.4 It has left some farmers without any secure market for their milk, without any sense of ownership or ability to influence the price they receive for their milk. They have become the ***"ultimate price taker"*** at the hands of independent corporate processors interested only in maximising returns to shareholders.

1.9.5 These corporate companies will only ever pay the bare minimum price for milk to secure supply. Any gains achieved through adding value or innovation will be retained by them for their shareholders, even though it may involve additional cost to the producer.

1.9.6 In addition to this, the consumer has yet to see the full benefits of the reduced milk price, as the Supermarkets are taking the opportunity to increase their margins on these products as well.

1.9.7 Producers have no position of power from which to negotiate a better deal.

1.9.8 All the benefits for producers of a vertically integrated industry, aiming to maximise returns to members while at the same time undertaking activities for the benefit of the industry as a whole, have been lost.

1.9.9 This situation has been replicated through the industry into the breeding, advisory and milk recording activities previously undertaken by the MMB. Each of these activities has been divested into separate companies (Genus and National Milk Records) where the shareholding has already or will ultimately no longer be solely in the hands of farmers.

1.9.10 As each of these organisations strives to increase returns to shareholders, they are looking to expand their activities outside the provision of cost effective, efficient services for dairy farmers. Their focus shifts away from the needs of dairy farmers, who are perceived as being a diminishing market with reduced spending power.

1.9.11 In their attempts to expand their business, Genus and NMR also appeared to be on track to compete against each other in the advisory fields with the different software packages they were developing. To me, this seemed to be leading towards a massive duplication of resource.

1.9.12 At a time when many agricultural organisations around the world are looking to combine resources to build critical mass and achieve economies of scale by reducing duplication and more efficiently using resources, this fragmentation of the UK dairy industry seems to be contrary to this trend.

1.9.13 Furthermore, as increasing pressure comes on to reduce prices (to remain competitive), there is a limit to the amount of efficiency improvements that are possible. Once this point is reached, any price reduction will result in a decline in the availability of service, particularly in remote areas and areas that are “for the industry good”. Genus has already signaled this warning in its 1997 Annual Report. This action could further exacerbate problems for many UK farmers in the future.

1.9.14 Taking all this into account, but more particularly because most dairy farmers I met told me they were experiencing the worst returns from their farms they could ever remember, I would have to conclude that deregulation in the UK has not been the success it was hoped for.

Part 2 – Corporates vs Co-operatives in the Dairy Industry

2. Ireland

2.1 Background

2.1.1 The Irish dairy industry involves approximately 39,000 suppliers milking 1.3 million cows. Average herd size is only 32 cows and like the UK, the predominant breed is Friesian.

2.1.2 With a population of just over 3.5 million, only 10% of the total milk production goes into liquid milk with a further 10% being sold as product on the domestic market, leaving 80% to be processed and exported. This makes it similar to New Zealand from that point of view.

2.1.3 Producers supply their milk to one of 35 processing co-ops or *plcs* (public listed companies). These entities not only process the milk but are also able to market the product themselves.

2.1.4 The four biggest processors are:

Company Name	*No Suppliers*	*Volume Processed (million litres)*	*Turnover $NZ Billion*	*Structure*
Avonmore Waterford Group	6,000	1,180	6.400	***Plc/***Co-op
Dairygold	5,000	800	1.665	100% Co-op
Golden Vale	3,500	540	1.525	***Plc/***Co-op
Kerry	4,500	480	4.000	***Plc/***Co-op

2.1.5 These four entities comprise 66% of the total processing capacity in Ireland. As can be seen, the turnover of AWG is almost as much as that of the New Zealand Dairy Board ($7.7 billion).

2.1.6 All of these entities are not only involved in dairy food processing, but also meat and small goods as well as agri-trading activities.

2.1.7 On top of these key processors/marketers, the Irish Dairy Board also operates as the major international exporter of international dairy products. It is a co-operative and its function is to market and distribute the products of its members (all manufacturing co-ops or companies). It does not operate any processing facility in conflict with any of its member manufacturers.

2.1.8 Average milk price received by the Irish farmer is almost double that received by a New Zealand farmer and the average cost of production is approximately 65% of Gross Income.

2.1.9 One of the most frustrating issues for an Irish dairy farmer is Milk Quotas. The only way to increase the scale of a dairying operation is to buy or lease quota and even this is less attractive now due to the recently introduced "clawback' provisions.

2.1.10 Milk quota can only be bought or leased if the land to which that quota applies is also bought or leased. This means that many farms acquire small blocks of land that they really do not want to farm. They end up running drystock on it, simply in order to "use" it.

2.1.11 From 1 April, 1998 the "clawback" provisions mean that any quota that is leased will be reduced to 80% of it's original volume when it is returned to the original owner. This is a political attempt to redistribute quota to smaller, less profitable units and also to younger farmers. However, it is simply another disincentive to lease.

2.2 The Irish Dairy Board (An Bord Bainne)

2.2.1 The Irish Dairy Board exports approximately 60% of all dairy products manufactured in Ireland and has an annual turnover of NZ$3.5 billion.

2.2.2 It owns the ***Kerrygold*** brand, which is one of the Irish dairy industry's most important marketing assets. Also, any sales of Irish Dairy product into Intervention are managed by the IDB.

2.2.3 Basically, this co-operative disposes of all product that the manufacturing companies are unable or unwilling to find a market for, therefore it is largely a commodity trader. It is a purely marketing and distribution organisation selling branded product and commodity goods.

2.2.4 The philosophy of the IDB is to try to add value by building a global infrastructure supported by brands. However, current efforts are concentrating on increasing sales within the EU.

2.2.5 Product is purchased from members at an agreed "standard" price based on a combination of international market prices, currencies and the Intervention Price. Any "profits" are bonused out to members at year-end, based on the value of trade. Members then pass these bonuses onto farmers either as a dividend or as a top up to milk price.

2.2.6 While it would seem inevitable that the IDB is left with the more difficult product to sell, it seems to provide some level of competition for the ***plcs.*** It also accepts the challenge that it's survival depends upon its ability to provide some incentive to companies to continue to sell through it, in the form of best price and longer term stability.

2.2.7 All of the major milk processors are members of the Irish Dairy Board, although the Kerry Group does not currently do any trade with the IDB, preferring to take full responsibility for marketing and distributing all it's own product.

2.2.8 Kerry believes that the IDB is ineffective because it does not have the technical expertise to feed back to the industry what is happening in the market place. Even if it did, the membership structure of the Board would mean that individual members would be unhappy if one member got "preferential" feed back based on market demand or performance. So feedback doesn't happen and the industry continues to manufacture butter and skim milk powder. While Kerry believes that the IDB does fulfil a need for strong centralised commodity trading, its overhead costs are too high.

2.3 Public Listed Companies *(plcs)*

2.3.1 Public Listed Companies are limited liability companies, whose shares are listed and traded on the Stock Exchange.

2.3.2 The shares may be purchased by anybody willing to invest in that company and able to pay the current market price for those shares. Shareholding is not restricted to suppliers, members, institutions or employees. Anyone can invest.

2.3.3 Investors look for a return on their investment, either by way of dividend flow or capital appreciation in share values as the Stock Market price increases or profits are distributed by way of bonus issue shares.

2.3.4 Companies usually seek a public listing in order to raise equity or capital for growth and development of the business. The funds raised by the initial listing of shares are used by the company to fund that process.

2.3.5 Once investors have taken up the initial allocation of shares, the shares can then be traded on the Stock Market, where the transfer price is determined by supply and demand, based on the performance of the company.

2.4 Public Listed Companies *(plcs)* in the Irish Dairy Industry

2.4.1 Until the mid-1980s, all the dairy processing companies in Ireland were farmer owned co-operatives. There were approximately 45 such societies in 1984, but the industry was largely dominated by 6 large multi purpose co-operatives.

2.4.2 As well as dairy processing, the big 6 also engaged in agri-trading business, feed milling, farming and some also engaged in pig meat and beef processing, AI and livestock trading. However, approximately 2/3 of their turnover was from dairy products.

2.4.3 Products were largely commodity based and centered on butter, cheddar cheese and milk powder.

2.4.4 Milk output expanded rapidly in response to increased prices after Ireland joined the EEC in 1973. This put considerable pressure on processing facilities and meant any investment was targeted at increasing processing capacity rather than adding value to products or innovation. Costs were increasing, due to interest charges, while returns from product sales were relatively stagnant and even declining. Farmers were relying on increased production to maintain profitability.

2.4.5 Then, in 1984, along with the rest of the EEC, Milk Quotas were imposed in Ireland thus limiting the opportunity for these dairy processing companies to grow their business organically and improve returns for their farmers.

2.4.6 Furthermore, at about the same time, a co-op raider called Larry Goodman, was offering to buy co-op shares at above par value. This was creating significant interest among co-op shareholders as to what the real value of their investment in the co-operative was. This was particularly of interest to those "dry" shareholders who no longer had a business relationship with the co-op in terms of supplying produce or buying goods but could see an opportunity to realise some capital previously invested in the co-op.

2.4.7 The big 6 dairy co-ops were forced to think seriously about strategies for future growth. These strategies revolved around diversification, both in terms of product range and geographical location of markets. The need for capital to fund these plans for expansion eventually resulted in four of the big 6 processors becoming ***plcs.*** Furthermore, four of these companies merged into two larger companies. I was able to visit each of these four companies during my time in Ireland.

2.5 Kerry Group *plc*

2.5.1 Kerry was the first co-operative to go down the ***plc*** route. This is because they were the first dairy company to recognise the need for corporate planning. In 1979, they had just borrowed and invested heavily in increased processing capacity in response to cumulative production increases of over 40% in the previous 3 years.

2.5.2 Then the Government brucellosis eradication scheme drastically reduced cow numbers in Kerry and production volumes declined by a cumulative 15% over the next 3 years. Production overheads had increased and there was a smaller volume of milk over which to spread these overheads. "Top management in Kerry got one hell of a shock……we were in serious trouble; we had to find another way."

2.5.3 The management team set a major corporate objective to profitably expand the business and increase income to shareholders and suppliers by:

- embarking on an R&D program aimed at adding value to each gallon of milk produced
- redefining Kerry as a food business rather than just a milk processor in order to reduce the co-ops dependence on milk.

2.5.4 **Strategy**

The implementation of this strategy involved:

- investment in operating process and labour efficiencies as well as energy savings that ultimately cut costs
- acquisition of liquid milk businesses and meat plants that would form the basis of profitable and stable food businesses
- the development of members' representative system based upon a tiered structure of elected members to local committees, advisory committees and ultimately the Board of Directors. While this system may appear large, it allows for an excellent and quick flow of information between executive management and suppliers
- the establishment of completely autonomous business units set up as profit centers. Each profit center pays for group services such as R&D and top executives are well rewarded by bonuses and promotion based on performance. A strong centralised control function monitors these profit centers closely
- executives able to take up share options in the company as a further incentive to encourage high performance
- an approach to production and marketing that focuses on identifying a "niche" market where Kerry can be the dominant player or at least the alternative supplier to a customer. While branding is recognised as being important in the Irish and UK market, the international focus is upon building a reputation as a key ingredient supplier of producer goods offering excellent quality and service. (The cost and risk of trying to compete in the consumer markets with branded products against multi-nationals is considered too high.) This means the R&D people may spend 50% of their time helping customers solve their problems. The feedback and link between the market place and technical development is considered essential so that the company can produce what the market wants
- a recruitment policy that means that 25-30 graduates are hired each year for management positions. Marketing graduates spend their first 6 months on the factory floor to acquire technical skills and preference is given to multi-lingual applicants in order to ensure strength in the marketing team when it comes to negotiating with international customers. All graduates are on a 6-12 month probation period to ensure they fit into the Kerry culture
- an emphasis on good farmer relations based upon paying a high milk price, integrity (keeping their word and delivering the level of performance promised) , and a good communication network between management and suppliers

2.5.5 **Philosophy**

These actions are reinforced by philosophies such as:

- "we act to help our farmers if they have difficulties, before they react to abuse us……..we shoot local managers who do not treat farmers fairly"
- "we create the markets first. Then we believe we will always source supply somewhere"
- "we believe that a business short on capital can borrow money. One with a poor location can move. But a business short on leadership has little chance of survival"
- "if we are too big in a small market, we are too vulnerable"

2.5.6 It is worth noting that the Chief Executive Management team of this company has consisted of three key men since the co-op began trading in 1974; Denis Brosnan, Hugh Friel and Denis Cregan. Denis Brosnan is the CEO and the man credited with the vision that has been translated into the successful food business that the Kerry Group has become. He often quotes Peter

McArthur who said "Every successful business requires three men – a dreamer, a businessman and a son of a bitch". This team has been at the helm of this company for 25 years – has this been the secret to the success? (One farmer/investor commented to me that he may sell his shares if and when the current management team changes.)

2.5.7 **Success and Options for Growth**
The implementation of this strategy was very successful. Turnover increased from NZ$56 million in 1974 to NZ$570 million in 1984. Kerry was able to pay a milk price to farmers approximately 3-4% higher than that paid by surrounding co-operatives. This made them even more attractive to suppliers from surrounding co-operatives and Kerry accepted them as new suppliers.

2.5.8 This was against a traditional unwritten agreement between co-operatives whereby co-operatives would not grant permission to transfer milk supply from another co-operative. A milk price war resulted between nearby Golden Vale and Kerry.

2.5.9 Kerry approached Golden Vale with a view to merging the two co-ops. Kerry needed more raw material to supply their growing markets. Golden Vale had quality raw material but was under-performing .

2.5.10 The management of Golden Vale were suspicious of Kerry's motives and rejected the approach out of hand. They saw the move as being too fast, too pressured at a time when the milk war was still raging and they wanted an independent analysis of situation.

2.5.11 Kerry realised that the merger would not happen. There were too many vested interests trying to preserve the status quo. Trade unions, existing management, financiers, advisors and the Irish Dairy Board were all trying to protect their own positions and interests, even though the merger would have resulted in higher milk prices for Golden Vale suppliers.

2.5.12 While Kerry believed that expansion of their core business would best be achieved by an amalgamation with Golden Vale, when it became obvious this wouldn't happen, they decided to buy milk powders both at home and abroad to fill their markets. This initially meant buying milk powders in the US and adding value to it at a plant Kerry operated in Minnesota. Current policy is to buy raw milk only from farmers in Ireland. Internationally, only product is purchased from processors for further processing.

2.5.13 They also decided to become a ***plc*** in order to raise the equity necessary to sustain growth and continue expansion by acquisition of global food businesses that fit with their overall objective of building a profitable, diversified and stable food company.

2.5.14 **Becoming a *plc***
The initial co-operative was called Kerry Co-op Creameries and is owned 100% by farmer suppliers. In 1986, this co-op floated a subsidiary, Kerry ***plc.*** All the business and assets of the co-op were transferred to the ***plc*** in exchange for shares in the ***plc.*** Initially, the co-op retained control of the ***plc*** through ownership of not less than 51% of the shares in the ***plc.***

2.5.15 Before listing on the Stock Exchange, almost NZ$10 million was raised by selling shares in the ***plc*** to employees and shareholders at a preferential price of 35 pence (NZ$0.945) per share. When the ***plc*** officially listed 4 months later, the shares were listed at 45 pence (NZ$1.215) per share. In total, over NZ$23 million in capital was raised when the ***plc*** was listed.

2.5.16 In 1996, the co-ops' shareholding in the ***plc*** was reduced to 39% by a "spin out" transaction. This is where the ***plc*** offers farmers 11 ***plc*** shares (at that time valued at NZ$16.20/share) for 1 co-op share. In total, 21.37 million ***plc*** shares were issued to farmers in exchange for 1.96 million co-op shares. These co-op shares were subsequently cancelled, thus reducing the co-ops shareholding in the ***plc.*** The farmers were able to "unlock" or realise a portion of their investment in the industry

that had previously been tied up in non-tradable co-op shares. This "spinout" resulted in them being allocated tradable shares in the ***plc*** with a current value of NZ$346 million.

2.5.17 Since then, more shares have been issued in the ***plc*** and an employee share option scheme has been introduced, resulting in the co-op shareholding being diluted to 35%. The current company rules allow for this shareholding to drop as low as 20%.

2.5.18 The question of loss of control doesn't appear to have become a very big issue yet, perhaps because the culture of a Kerry farmer means that few of the shares allocated to them have actually been traded by them. Historically, Kerry farmers have not "sold" or disposed of their assets.

2.5.19 Also, the management of the company believes that Kerry farmers would "rather own 30% of a NZ$6 billion company than 100% of a NZ$500 million company."

2.5.20 **Results and Achievements**

- the company has achieved it's goal to grow it's business by an average of 15% per annum
- it has become an organisation that has many different businesses depending on different raw materials and different consumers in various countries around the world. When one area is down, hopefully returns from another area will compensate.
- farmers incomes comprise not only milk price, but also dividend flow and capital growth in share values

2.5.21 Turnover has increased from NZ$570 million in 1984 to NZ$4 billion in 1997.

2.5.22 In 1984, total turnover was generated from sales in Ireland. By 1997, approximately 1/3 of the turnover was generated in Ireland, 1/3 in the rest of Europe and 1/3 from North America.

2.5.23 The dividend paid in 1996 was 3.83 pence per share (NZ$ 0.103). This was a 15% increase on the dividend paid the year before.

2.5.24 Share price in April '98 had reached 11 pound per share (NZ$29.70), although by September, as a result of the global economic crisis, this had fallen to 7 pound 40 pence (NZ$20). Those farmers who owned 100 pounds (NZ$270) worth of co-op shares in 1972, could now have shares in the ***plc*** worth 30,000 pounds (NZ$81,000).

2.5.25 The company still pays one of the highest milk prices in Ireland.

2.5.26 In addition to this, suppliers are invited to purchase "patronage shares" in the ***plc*** each year at a cost of 1 pound (NZ$2.70)per share. These patronage shares are allocated on the basis of 1 share for every 500 gallons of milk supplied. They offer shareholders the opportunity to make a voluntary investment in their company, at a much discounted price.

2.5.27 The business was now divided into three sectors:

- Kerry Ingredients concentrates on supplying specialist food ingredients to the food service sector around the world. These ingredients center around coatings and flavourings based on casein and caseinate as well as cheese. This division accounts for 57% of total turnover and 72% of operating profit.

- Kerry Foods is the consumer foods business and is based on branded products as well as own label products that range from meat and poultry small goods to fruit juices, flavoured mineral waters, liquid milk and dairy products. This division accounts for 39% of total turnover and 27% of operating profit.

- Kerry Agribusiness is the link to the farmer. It is responsible for milk collection and payment to farmers and also supplies a range of products and services to farmers

including an AI service, an advisory service, feed products and fertiliser. They are also involved in pig production. The focus is to help farmers become least cost producers. This sector no longer has a profit target and only accounts for 4% of company turnover and 1% of operating profit.

2.5.28 **Reservations**
While many of the original shareholders are well pleased with the performance of their company, newer and younger suppliers are concerned that their future income stream will be limited and will almost entirely rely upon milk price.

2.5.29 This is because the current share price for ***plc*** shares is too expensive for these farmers to acquire. Although they are able to acquire "patronage shares" at a discounted price, it is a slow process to build up a significant shareholding.

2.5.30 Because they have few ***plc*** shares, the opportunity to earn income from dividend flow or capital appreciation is limited. The majority of their income will be from milk price.

2.5.31 While there is still a large farmer owned co-operative in the market place (Dairygold) paying a good milk price, then milk price will be maintained. But there is some concern as to what will happen if that co-operative disappears.

2.5.32 Also, as the business has grown, considerable investment has been made in higher margin activities and business acquisitions. Some farmers are concerned that the company will lose its milk/farmer focus. Combined with reduced farmer control and the possibility of increased pressure from majority shareholders to increase dividend flow, these farmers are concerned about the ability (or the desire) of the company to continue to pay a good milk price.

2.5.33 There seems to be some conflict between younger shareholders concerned about their future in the industry and older shareholders looking for cash and retirement assets. I understand for instance, that it was largely the older shareholders that voted for the motion that allowed farmer control to fall below 50%.

2.5.34 Some farmers also believe that the company should have approached existing shareholders for additional capital BEFORE they issued more shares in the company on the Stock Exchange.

2.6 Avonmore

2.6.1 Avonmore Creameries was formed in 1973 out of the merger of 35 smaller co-operatives.

2.6.2 Like Kerry, this company underwent a major reorganisation in 1988, as a result of the development of a new growth strategy based upon diversification of both product range and geographical location of markets. The introduction of Milk Quotas had pre-empted the development of this new strategy, as growth by volume was no longer possible.

2.6.3 A plan was drawn up in 1986 to shift from basic commodities to niche markets directed at larger, international population bases. This involved developing new products and acquiring other types of food businesses, some of which were overseas. To do this, they needed CAPITAL – estimated to be in the vicinity of 50 million pounds (NZ$135 million).

2.6.4 In 1988, Avonmore Foods ***plc*** was established and acquired the assets of the co-operative in exchange for 73 % of the shares in the ***plc.*** By 1996, the co-ops holding in the ***plc*** had fallen to 64%.

2.6.5 Farmers were also offered the opportunity to acquire shares at 35 pence per share and like Kerry, when the ***plc*** was officially listed on the London and Dublin Stock Exchange the shares began trading at 45 pence per share.

2.6.6 Approximately NZ$86 million was raised in this initial float.

2.6.7 Avonmore proceeded to acquire meat companies in Ireland, the UK and Europe where they processed pork, beef and lamb and developed markets in Japan, Korea, Thailand, China, USA, UK, France, Germany, Italy, Algeria and Israel.

2.6.8 They also acquired liquid milk businesses in the UK near Birmingham and now have a 50% share of the liquid milk market in an area where the population is approximately 7-8 million people.

2.6.9 They purchased a small cheese business in North Wales producing 3,000 tonnes of cheese and have developed it to a production capacity of 15,000 tonnes of mozzarella and pizza topping cheeses. This plant together with a plant in Belgium and a 25,000 tonne plant in Northern Ireland has enabled Avonmore to become the sole supplier of Pizza Hut in Europe.

2.6.10 They expanded into the USA and acquired cheese plants in Wisconsin and Idaho supplying cheese to the catering industry. They have built a whey protein business in the USA supplying ingredients for the nutrition and health care industry. The knowledge and skills developed in the USA are now being transferred to build a customer base in Europe.

2.6.11 In total, Avonmore ***plc*** invested over NZ$330 million and acquired 31 businesses globally.

2.6.12 The philosophy has been to build flexibility in processing plants, in products and in markets. Every attempt is made to get as close to the customer as possible to ensure that production is market driven.

2.6.13 Turnover has increased from NZ$70 million in 1987 to NZ$3.5 billion in 1996.

2.6.14 By 1996, only 25% of the total turnover was being generated in Ireland, 48% was being generated in the rest of Europe and 27% from other countries, mainly the USA.

2.6.15 Dairy products (consumer and ingredient) accounted for 58% of total turnover, meat products 33% and agri-trading 9%.

2.6.16 The dividend paid per share in 1996 was 4.5 pence (NZ$0.125) per share. This was a 10% increase on the dividend paid the year before.

2.6.17 The increase in share value was not as spectacular as that of Kerry. Where shares were initially traded at 45 pence (NZ$1.215), their value in April when I was there had reached approximately NZ$8.60 per share.

2.6.18 But just like Kerry farmers, their suppliers income was comprised of milk price + dividend flow + capital appreciation in share values.

2.7 Avonmore Waterford Group

2.7.1 In September 1997 Avonmore and Waterford ***plcs*** merged.

2.7.2 Waterford had previously been one of the big six co-operatives who dominated the Irish dairy processing industry. They had also followed the ***plc*** route, but their success had not been anywhere near as spectacular as that of Kerry or Avonmore.

2.7.3 Their Board and management team were perhaps not as astute as those of their peers and the acquisition of the Cheese Company in the UK, put severe pressure on the financial performance, resulting in lowered milk prices and a high level of borrowings.

2.7.4 Waterford also had a significant number of "dry" shareholders – almost 50% of shareholders no longer transacted business with the company either by way of supplying milk or purchasing goods and services. These people were interested in protecting their investment as much as possible, but had little or no interest in maintaining the company as a farmer's business. They were open to offers of a takeover.

2.7.5 Avonmore, on the other hand, recognised that a merger with Waterford would generate benefits in terms of scale and rationalisation. The strong market positions of both companies and critical mass would enable the new company to keep pace with the globalisation of the food industry and the consolidation of the retail sector internationally.

2.7.6 There were significant synergies between the two companies in Ireland, the UK and the USA. Waterford had a liquid milk business in the UK – the merger would mean that AWG has 13% of the total liquid milk market in the UK (pop 58 million). The Cheese Company in the UK previously acquired by Waterford, means total cheese production of AWG is now 70,000 tonnes. Businesses in Wisconsin, previously owned by the two separate companies were combined and then sold off to allow the enlarged company to focus on food ingredient activities in large scale plants in Ireland and the USA.

2.7.7 In 1997, turnover of the new company reached NZ$6.4 billion. The company paid a dividend of 4.9 pence per share (NZ$0.13), up 9% on the previous year.

2.7.8 Consumer foods comprised 45% of total turnover, food ingredients 27%, meat 20% and agri-trading 8%.

2.7.9 AWG is now among the 10 largest dairy companies in Europe.

2.7.10 As a part of the merger process, both companies performed a "spin out" whereby 10 ***plc*** shares were exchanged for 1 co-op share. As an enticement to farmers to approve the merger, NZ$180 million worth of ***plc*** were allocated to farmers in exchange for non-tradable co-op shares.

2.7.11 This effectively reduced the co-op shareholding in the new ***plc*** to 55% and current management seem willing to let this fall below 50% if necessary to raise capital to fund future growth and expansion.

2.7.12 I met some farmers who were concerned and unwilling to let this happen. They believed farmer control was very important and if it fell below 50%, they would like to see the co-op buy back the dairy processing facilities and then onsell product to AWG who would be responsible for marketing and distribution. This would allow the farmer to retain some measure of control over processing, and also enable the ***plc*** to pursue its growth strategy. The big issue is how the co-op could fund the re-purchase of the processing facilities.

2.8 Golden Vale

2.8.1 Golden Vale is also one of the "big 6" who has dominated the processing sector of the Irish Dairy industry in recent years.

2.8.2 They formed a ***plc*** in 1989, largely in response to the interest in "unlocking" share values created by the co-op raider Larry Goodman, but also because it seemed fashionable at the time.

2.8.3 Current shareholding is approximately 50% farmer owned and 50% employee/private investor (mainly institutional investors).

2.8.4 Like Waterford, the results achieved since corporatisation have not been as spectacular as Kerry or Avonmore.

2.8.5 Turnover has increased from NZ$520 million in 1989 to NZ$1.525 billion in 1997.

2.8.6 The product base is still largely dairy based and the majority of markets are located in Ireland and the UK with additional markets in Holland and Denmark.

2.8.7 This company seems to be under extreme pressure to perform in terms of milk price when compared with Dairygold.

2.8.8 The dividend paid in 1997 amounted to 2.5 pence (NZ$0.07) per share.

2.8.9 The company executive I met with made some interesting comments about the success of becoming a ***plc.*** These included:

- the public listing of shares only raised $NZ60 million additional capital
- the total capital of the company is NZ$216 million, but the majority of this was issued to co-op shareholders in exchange for the co-op assets
- this capital now incurs an ongoing and never ending "cost" by way of dividend that could otherwise be used to increase milk price by 2.95 pence per gallon (NZ 1.8 cents per litre)
- since corporatising, the company has invested NZ$350 million
- corporatisation puts increased pressure on a company in terms of Stock Exchange reporting requirements and performance in terms of growth in earnings per share. These demands and pressures are not always conducive to supporting long term development and growth
- he didn't believe that co-operatives such as Dairygold had to deal with the same pressures. Dividend requirements were not as high and so more funds could be paid out as milk price. For this reason, he didn't believe it was fair to compare the milk price paid by a co-op to that paid by a ***plc***
- *on reflection, he wouldn't recommend his company going public as he didn't believe it had achieved anything that it couldn't have achieved as a co-operative.*

2.9 Dairygold

2.9.1 Dairygold is the only one of the "big 6" that still remains a 100% farmer owned co-operative. It merged with another of the "big 6" , Mitchelstown in 1990.

2.9.2 It has just under 5,000 suppliers and processes 20% of the milk supply in Southern Ireland.

2.9.3 It has a reputation for consistently being among the top five performers in Ireland in terms of milk payout.

2.9.4 Like the other large processing companies, its business encompasses dairy foods (52% of total turnover), meat products (26%) and agri-trading (22%).

2.9.5 Unlike the other large companies, almost 60% of sales are still based in Ireland and only 10% are based outside Europe.

2.9.6 Total turnover was NZ$1.665 billion in 1997 compared to NZ$1.2 billion in 1990 when the current co-op was formed, so the rate of business growth has not been anywhere near as spectacular as that of even the poorer performing ***plcs.***

2.9.7 The product range is similar to that of the other companies and the co-op also produces Kerrygold butter under license for the Irish Dairy Board.

2.9.8 Shareholding in the co-op is voluntary. There are approximately 8,000 active shareholders and 3,000 dormant shareholders. To be a shareholder, a person must own land in the area and either:

- be a milk supplier
- be a pig producer
- have developed a trade relationship with the co-op

2.9.9 New shareholders must purchase a number of shares based on the volume of business traded with the co-op. Voting is based on 1 man, 1 vote.

2.9.10 All shares earn a dividend equivalent to 2.5% pa.

2.9.11 For the last 7 years, bonus shares have been allocated at the rate of 1 share per 900 litres supplied. This has served to increase a farmers shareholding over time so that a 100 pound (NZ$270) investment made 25 years ago is now worth 15,000 pounds (NZ$40,000).

2.9.12 Shares can only be redeemed when a farmer retires and sells them back to the co-op. Even then, this is only at the pleasure of the co-op. It is possible for these shares to be transferred to direct family members.

2.9.13 The executives I met with at Dairygold did not believe that the need to raise capital was always the reason for becoming a public listed company, as ***plcs*** still tended to have traditional borrowings. However, they did acknowledge that listing often strengthened a company balance sheet enabling that company to borrow more funds.

2.9.14 They also believed that farmer loyalties were changing as pressure on farm incomes increased, and so the potential for farmers to sell their ***plc*** shares was increasing.

2.9.15 They did not discount the possibility that their co-op would go down the ***plc*** route eventually, but thought this would be driven by the farmers' desire to "unlock" their stake in the industry.

2.9.16 The focus of this co-op was definitely farmer-oriented. The company executives stated that the objectives of the company were "to provide a continuous processing capacity for farmers' produce and at the same time maximising farmers' incomes." They also want "to provide products and services to these farmers at competitive market rates". The aim is to "maximise price to farmers for produce, consistent with running a commercial business on a competitive basis over the long term".

2.9.17 While some would criticise Dairygold for it's poor performance in terms of business growth, there is no doubt that it's performance to date in terms of milk price is ensuring competition is maintained at a level that benefits all milk suppliers in Ireland.

2.9.18 The question is whether Dairygold can continue to maintain this level of performance or will the globalisation of the food industry and the consolidation of the retail sector force it to invest heavily in diversification of both products and markets? If investment is required, where will the funds come from? Will outside equity be required? What will happen to milk price in Ireland if this co-op ceases to be the competitive benchmark for milk price?

2.10 Newmarket Co-op

2.10.1 Newmarket is a small co-op of 700 shareholders (only 250 suppliers) that processes all it's milk into 7,000 tonnes of cheese, 93% of which is sold in the UK by the Irish Dairy Board under an Irish Cheddar label.

2.10.2 They are determined to survive as an independent co-op and aim to pay the same milk price as Dairygold.

2.10.3 The management of this co-op believes that small co-ops are valuable as they maintain competition, which in turn maintains a higher milk price.

2.10.4 Their perception of the corporate process was worth noting. They believed that it was a circular process.

1.Co-ops are created to protect farmers from private monopolies

2.Co-ops merge to gain critical mass and size in the market place

3.Co-ops convert to plcs to raise capital, recognise a market value for shares and measure performance of management

4. The company's focus moves to dividend yield as opposed to milk price

5. Farmers as producers of raw materials become price takers and lack of competition ensures milk price is minimised

6. Farmers form supply co-ops to give them critical mass and size in the marketplace

After visiting the UK, where I saw the effects of a poorly managed deregulation process, followed by my trip to Ireland where corporate dairy companies dominate, I travelled to Holland and Denmark and visited two of the largest dairy co-ops in Europe. Both of these co-ops are 100% farmer owned and both of them achieve levels of turnover that rival that of the New Zealand Dairy Board.

3. Holland

3.1 Background

3.1.1 There are approximately 32,000 dairy farms in the Netherlands milking a total of 1.2 million cows. Average herd size is about 50 and average per cow production is almost 8,000 litres or 630 Kgs milksolids.

3.1.2 Processing is dominated by two very large co-operatives; Friesland Coberco in the north and east takes 57% of Holland's total production and Campina Melkunie in the south and west accounts for approximately 24% of total supply. Other very small co-operatives (140-600 members) account for 12-15% of processing and Nestle would source approximately 8% of total supply.

3.1.3 The Netherlands is 189% self-sufficient in dairy products so a significant portion of their production is exported.

3.1.4 The population of the Netherlands is 15.5 million and only 4% of the labour force is employed in agriculture. Agriculture contributes 3% to total GDP.

3.1.5 As a result of historic problems, the dairy industry now seems to be highly regulated in terms of environmental and hygiene controls. The general population does not seem to be supportive of farmers and regard dairy farms as smelly and environmentally unacceptable. They would prefer to see "pet" animals rather than producing animals and generally speaking would rather import their food and do away with agriculture altogether.

3.2 Friesland Coberco Dairy Foods

3.2.1 Friesland is the largest dairy co-op in the Netherlands and was formed in January 1998 by the merger of four smaller co-ops.

3.2.2 The new co-op will be the 3rd largest multi-national dairy company in the world behind Nestle and Danone in France. Campina Melkunie is the 5th largest.

3.2.3 It has 15,000 dairy farmers, (more than the total number of dairy farmers in New Zealand,) supplying 5.1 billion litres of milk pa.

3.2.4 Total annual turnover is more than NZ$8.5 billion, of which 43% is domestically generated, 30% from the rest of Europe and 27% from the rest of the world, mainly South East Asia, Africa and South America.

3.2.5 The co-op has processing plants in Indonesia, Malaysia, Thailand, Nigeria, Viet Nam, China, Peru, Columbia, Guam, Saudi Arabia and Poland. It employs 12,000 people around the world and has total assets worth NZ$3.5 billion. The goal is to maintain an equity level around 35-40%.

3.2.6 The main product is cheese (35%) and international sales of mostly milk powders (17.5%) followed by consumer long life milk (12%), fresh milk (7.5%) and butter (7.5%). They are also involved in fruit juice, food ingredients, catering ingredients, consumer dairy products such as yoghurts, flavoured drinks and baby foods.

3.2.7 The company has 78 processing sites globally, 34 in Holland but these are slowly being rationalised down.

3.2.8 One of the primary reasons for this recent merger is to capitalise on the power generated by size. Management believes that the merged company is now in a better position to perform in

increasingly competitive markets, especially in Europe and also to maintain an equal position of negotiation with the large (and growing) retail outlets. They believe that as the supermarkets get bigger, it is important to grow as well to maintain the company's level of importance to their organisation as a "preferred supplier".

3.2.9 **Ownership Structure**
Farmers are members of the co-operative company. This co-operative has A and B shares.

3.2.10 A shares are allocated to farmers based on the volume of milk supplied. They do not have to purchase these shares – they have been built up over the history of the co-operative and their "cost" is reflected in the purchase price of the supplying farm, much as they used to be in New Zealand. However, if a "new" supplier wants to join the company, then he must buy his allocation of shares, currently the cost is 19c/litre. They are not transferrable, but are linked to the right to supply milk from a particular property.

3.2.11 B shares are purchased voluntarily by the farmers or their immediate families. Currently there are 22,000 B shareholders holding 1.4 million shares. B shares represent the extra cash investment a farmer has made into the company. They give him the opportunity to choose the level of investment he wishes to make into the industry and separate it from his investment in his farm.

3.2.12 At present, B shares do not hold any voting rights. As the co-op needs more capital, more B shares are issued. So far, farmers have been willing to invest all the capital that has been required, but should this not be the case in the future, B shares may have to be made available to outside investors. The issue of control and voting rights, should this be the case, has not yet been addressed.

3.2.13 The co-operative, in turn, is the sole shareholder of the Friesland Dairy Foods Holding Company which owns all the business assets and operates the business activities through two subsidiary operating companies called Friesland Dairy Foods and Friesland International. The co-op has A and B shares in the holding company.

3.2.14 **Farmers' Income Stream**
As in Ireland, a farmer's income is comprised of milk price and dividend flow.

3.2.15 All members get paid a "market price" for their milk.

3.2.16 This market price is established indexing the movement in the milk price paid by five of the top dairy companies in Europe – MD Foods in Denmark, Campina in Holland plus 2 German and 1 Belgian company. The average movement in these companies milk price against a "base" price set in 1996 is then applied to the 1996 base price paid by Friesland which was 75 cents per litre. For 1998, the movement was calculated to be +3.5%, so farmers will be paid 77.625 cents/litre. (NB: actual payment is based on a Fat + Protein price, so the per litre price is just an average.)

3.2.17 Farmers get paid 95% of their earnings each fortnight and then final payments are topped up once actual results are known at the end of the year. There are also adjustments to encourage off peak production such as –5c/litre in summer and + 7c/litre in winter.

3.2.18 Farmers therefore know in advance what the current years milk price will be.

3.2.19 The company also knows what the cost of milk will be and is able to identify a "profit" at year-end after the cost of materials.

3.2.20 The policy for distribution of this "profit" is:

- 60% retained as reserves for reinvestment and R&D
- 40% paid to shareholders as dividends on A and B shares.

3.2.21 Both A and B shares qualify for the same rate of dividend, except that the dividend payable on A shares is capped at 1% above market interest rates ie the maximum dividend an A share can earn will equate to the interest rate + 1%. This is to reflect that there is less risk in A share capital.

3.2.22 If, after paying all A and B shares an equal dividend, there are any surplus profits still available for distribution, they are paid as a dividend on the B shares. This ability of the B shares to earn a higher dividend recognises the voluntary investment of some farmers in the industry and the associated higher level of risk on that investment.

3.2.23 At present, B shares can only be traded between members of the company. Rabobank manages a "trading day" once every 2 months where farmers tender a bid for these shares. If a farmer leaves the company, he can retain his B shares as long as he is not supplying another dairy company.

3.2.24 This scheme seems to be very popular among the farmers. A recent issue of 300,00 shares at a price equivalent to NZ$115/share was over subscribed and since September '97 (pre-merger) the market value of these shares had increased from NZ$81/share to NZ$138/share in February '98. The par value is NZ$95/share.

3.2.25 The only negative comment I heard about this share structure was that young farmers, who did not have surplus cash to invest in B shares, were concerned that they didn't get the opportunity to share in any "super profits". But then, that is the nature of investment – most often, it is older and more established people who have surplus finds to invest. As the company executive I spoke with said, the younger farmers should be encouraged that older people are still willing to invest in their industry.

3.2.26 **Voting and Governance**

The company is divided into 24 regions. The farmers in each region elect 5 representatives. This makes a total of 120 reps.

3.2.27 The Chairmen of the regions then propose nominations from within these 120 reps to sit on the Co-ops Board of Directors. The 120 reps then elect 8 farmer directors from these nominations to sit on that Board of Directors.

3.2.28 All of the Co-op's Board then also forms part of the Board of Supervisors of the Holding Company. This Board of Supervisors also includes 4 non-farmers, appointed by the farmers on the recommendation of the senior company executives. This makes a total of 12 Supervisors in all.

3.2.29 Their role is to advise, control and protect the farmer's interests.

3.2.30 Each region also has a young farmers group and one representative from this group meets with company reps monthly to promote two way communications between the company and young farmers.

3.2.31 **Impressions**

This structure seemed to me to be very successful. The company was achieving growth levels by raising capital from traditional sources and also from it's own farmers.

3.2.32 The members were given the opportunity to display their confidence in the company and share in the rewards of success.

3.2.33 To date, the farmers had not been forced to risk losing control of their industry and while they continued to be confident about the company's future, this would not seem to be an issue.

3.2.34 The establishment of a milk price based on comparison with other top performing dairy companies provided an opportunity for shareholders to measure performance in terms of "profit" and dividend flow. It was much more transparent than simply comparing milk price.

3.2.35 Like all businesses however, the success of this structure will depend on sustained performance in terms of return on investment for those "voluntary" investors. Also, as the number of farmers continues to decrease, the pool from which this voluntary investment can be sourced will also decrease. It will be interesting to see what Friesland Coberco will do if and when that pool runs dry.

4. Denmark

4.1 Background

4.1.1 There are just over 12,000 dairy farms in Denmark milking a total of 600,000 cows. Average herd size is about 52 and average per cow production is just over 7,000 litres or 550 Kgs milksolids. Total milk production is 4.4 billion litres pa.

4.1.2 Processing is dominated by two very large co-operatives; MD Foods takes 73% of Denmark's total production and Klover Maelk accounts for approximately 15% of total supply. Other smaller co-operatives (14) account for 6% of processing and private companies (17) process the balance.

4.1.3 Denmark is 159% self-sufficient in dairy products so a significant portion of their production is exported – approximately 75%.

4.1.4 The population of Denmark is 5.2 million and only 1.3% of the labour force is employed in agriculture. Agriculture contributes 6.4% to total GDP.

4.2 MD Foods

4.2.1 MD Foods is today the largest industrial company in Denmark and was originally formed in 1970 by the merger of four smaller co-ops. It is also one of the 10 largest dairy companies in Europe and has a reputation for being ruthless in their economic decisions regarding growth and amalgamations.

4.2.2 It has 8,700 dairy farmers supplying 3.2 billion litres of milk pa. The company is a truly 100% farmer owned co-operative. It costs farmers nothing to join the co-op and they leave with nothing.

4.2.3 Total annual turnover is more than NZ$6 billion, of which 35% is domestically generated, 45% from the rest of Europe and 20% from the rest of the world, mainly the Middle East, Central and South America and Japan. In particular, MD Foods accounted for 85% of Danish cheese exports.

4.2.4 The co-op has processing plants in the UK, Saudi Arabia, South Korea and Brazil. It employs 13,000 people around the world and has total assets worth NZ$3.2 billion. The equity ratio over the last 2 years was down as low as 25%. The executive that I met with did not believe this was of major concern at all.

4.2.5 The main product is cheese (36%) followed by liquid milk sales in Denmark and the UK (34%), powder products (17%) and butter and spreads (12%).

4.2.6 The company has 38 processing sites throughout the country but these are slowly being rationalised down. One cheese plant currently under construction will ultimately replace 6-7 separate plants when it is completed.

4.2.7 Within Europe, the company objective is to become the preferred supplier for the major retailing multiples and outside Europe they are concentrating on building markets in the Middle East, Japan and North America.

4.2.8 More recently, due to the removal of export subsidies under GATT, the company has refocused its exports (mainly cheese) from markets outside Europe to EU countries, where prices are higher. They have also concentrated more on adding value and building brands. Cheese sales to their largest market of Germany have doubled over the last 6 years and Lurpak butter recently displaced Anchor butter as the top seller in the UK.

4.2.9 **Company Structure**

The business is divided into five divisions with various subsidiary companies set up under each division responsible for specific activities:

- Home Market Division — responsible for the sale and distribution of cheese, butter and fresh products to Danish retailers
- Europe Division — sells cheese and butter within Europe and responsible for production of all export cheese and butter
- Overseas Division — sells cheese and butter to markets outside Europe
- MD Foods Ingredients — sells added value milk protein, milk powder, whey protein, cheese powder and other powder products
- Transport Division — collects milk from farmers for distribution to processors and distributes product to customers.

The separate subsidiary companies enable reporting, monitoring and performance measurement to be more clearly defined.

4.2.10 The transport division is the biggest haulage company in Europe. By controlling the distribution network for dairy products in Denmark, they have effectively been able to minimise the competition for dairy products on the local market. There are no other haulers capable of delivering dairy products and most competitors are not willing to invest the capital required to set up their own distribution network.

4.2.11 **Joint Ventures**

In 1992, MD Foods signed a financially binding co-operation agreement with their biggest Danish competitor, Klover in order to plan the allocation and use of raw milk received by the two companies with maximum efficiency. Klover is stronger in the home market than MD Foods and together the two companies have established three joint venture processing plants. I got the impression that the relationship was not all that happy between the two co-ops. MD Foods would like to complete a full merger with Klover in order to capture the savings that could be achieved by reducing duplicated effort in the market place, but Klover seems content to continue with the status quo. I was led to believe that MD Foods takes the majority of the responsibility for these joint ventures in terms of administration and staffing, but I didn't visit Klover so am unable to give their perspective of the situation. It was obvious however, that MD Foods felt that Klover was enjoying all the benefits of the arrangement without contributing equally to the effort required to make them a success.

4.2.12 In 1995, MD Foods also signed a co-operation agreement with the Swedish dairy company Arla, in the hope of strengthening it's position in Europe. They have established a joint venture company to develop, sell and market specialty products in Europe. They have also amalgamated production and sales of vending machine products into a joint company and combined their sales activities in Finland.

4.2.13 This relationship must be quite successful, as MD Foods is looking at more joint co-operation with Arla and any other interested organisations, in fact. (It was announced in March that from October 1998, MD Foods would handle all the UK business of Arla). They are committed to building on their brands, especially LURPAK, and also to extending their operations abroad by building a reputation and infrastructure to sell Danish dairy products and to compete against large companies. They also foresee a time when raw milk in Europe could become a scarce resource and they want to be ready to source cheap milk from other areas, such as Argentina, if necessary.

4.2.14 **Ownership Structure**

As mentioned earlier, this co-op is 100% farmer owned. Financing for the business has come from retained profits and borrowings and there was no reason to expect that this would change in the future. Both management and farmers were adamant they want farmers to keep control! They were not keen to put schemes in place that benefitted the few at the expense of the majority.

4.2.15 **Voting and Governance**

The supply area is divided into 6 districts. Each district has a regional chairman who automatically sits on the Supervisory Board.

4.2.16 Members elect regional board reps on the basis of 1 rep per 15 million litres of milk supplied. Currently there are 231 regional reps including 15 elected by the company employees. Voting is 1 man, 1 vote.

4.2.17 These reps elect from within their ranks, 7 farmers and 2 employees to sit on the Supervisory Board. This Board is therefore made up of 15 people – 6 regional chairman, 6 regional farmer reps and 2 regional employee reps.

4.2.18 The Supervisory Board appoints a 5 member Management Board, usually from within the company, to develop and present strategy for approval by the Supervisory Board.

4.2.19 This Management Board is supported by an extended Management Board comprising of 4 executives, 4 divisional mangers and the finance director.

4.2.20 The company also operates a Regional assembly which meets 3 times a year and is primarily a communication vehicle. Farmers are elected to this Assembly on the basis of 1 rep per 2 million litres supplied.

4.2.21 **MD Foods International *plc***

This company was formed in1990 with the main objective of acquiring the UK's 5th largest dairy, Associated Fresh Foods. Since then it has acquired a number of British dairies and now has 12% of the liquid milk market in the UK making it the 3rd largest liquid milk producer in the UK. Approximately 80% of the company's business is based in the UK with the balance occurring in Saudi Arabia, South Korea, Brazil and Argentina.

4.2.22 This is MD Foods only foray into attracting outside capital. Institutional investors financed approximately half of the capital for this company with the balance coming from MD Foods.

4.2.23 Financial performance has not been great, partly because they the original company management was retained, partly because they expanded too quickly and partly due to competition from supermarkets which has seen doorstep sales of milk decline significantly in the UK.

4.2.24 After unsuccessful negotiations with investors, in an attempt to raise more capital to secure the company's financial position, the company has been wound up with an estimated loss of almost NZ$340 million. The institutional investors lost all their money and MD Foods will take over all the debt and the company assets via a new subsidiary and attempt to resurrect the business.

4.2.25 Needless to say, the outside investors were not happy and MD Foods doubts that even if it wanted to, it would not be able to raise outside equity after this result.

4.2.26 **Impressions**

This company is a true co-operative interested only in maximising returns for its farmers. It appears to be very aggressive in its approach to business and definitely very aggressive in its level of borrowings.

4.2.27 Nevertheless, it has a reputation for paying the highest milk price in Europe. This may partly be a reflection of the fact that dividends to shareholders are not required.

4.2.28 It is difficult to say if this company will continue to grow and achieve, although I suspect that it's willingness to enter into joint ventures with other European dairy companies will help achieve this. As the world becomes smaller, geographical boundaries will no longer be a barrier to international dairy company mergers.

5. The USA

5.1 Background

5.1.1 After visiting Europe, it seemed logical to visit the USA on my way home. The primary reason for my visit was to gain an understanding of the New Zealand Dairy Boards operations in North America, but I also took the opportunity to visit the two largest dairy companies there – Dairy Farmers of America and Land O' Lakes.

5.1.2 The face of dairying in America is changing, particularly with expansion of the dairy industry in California, Idaho, New Mexico and Texas. Even farmers in the more traditional dairying regions were realising that scale of operation was the key to future profits. As farm units increase in size, the cost of milk production is declining.

5.1.3 There are 140,000 producers in America milking 9.3 million cows in an average herd size of 67.

5.1.4 However, there are areas where this is definitely not the norm. I spent a day visiting a dairy company and a farm in the Chino Valley in California. This dairy company had 325 suppliers milking 300,000 cows. Average herd size was 1,000 cows and average farm size was 100 acres. It was very intensive.

5.1.5 Developers for housing were gradually buying up the area. The actual farm I visited had just been sold for this purpose. The 100 acres sold for US$6.8 million.

5.1.6 The family planned to move up into Northern California where average herd size was closer to 3,000 cows and land prices were US$3-4,000/acre.

5.1.7 I also heard of a farmer in New York State milking 2,800 cows. His milk supply was so significant for the factory that he didn't have a vat, but simply passed the raw milk directly into waiting tankers. He was milking his herd four times per day and his plant was operating almost 24 hours per day.

5.1.8 I don't want to go into a lot more detail except to briefly describe the ownership structures of the two co-operative dairy companies I visited.

5.2 Land O' Lakes

5.2.1 Land O' Lakes is a 100% farmer owned co-operative with 9,000 suppliers collecting and processing 8% of the total US milk supply.

5.2.2 It is not only a dairy co-op but is also involved in agricultural feed supplies, seed and agronomy. It sources milk from throughout the US, but predominantly from the Midwest and Mid Atlantic regions.

5.2.3 During 1997, the co-op merged with a similar sized co-op in Pennsylvania and there were plans to continue this merger process with another co-op in the West.

5.2.4 Total turnover was over NZ$8 billion. The original purpose of the company when it began in 1921 was to produce butter. Today it is a large food and agriculture company whose product range has extended to include cheese, juice, yoghurts, dips, flavourings, nutrition products, meat products and deli foods. Most of the business is based on branded products (the Indian Maid).

5.2.5 **Ownership Structure**
It costs initially just $1 to join Land O' Lakes.

5.2.6 After joining, suppliers are issued "patronage shares" based on the volume of milk supplied. The current requirement is US$2.75/ 100 lbs of milk supplied (approx NZ$1.50 per kg milksolids).

5.2.7 Suppliers "pay" for these shares over time out of company profits due to them.

5.2.8 As in Holland, the company sets a milk price for the season. This price is based on a minimum price set by government plus any premium required to attract supply.

5.2.9 This means the company is able to identify a true profit remaining after all expenses including the cost of milk. For 1997, these profits equated to US30c/100 lbs milk supplied.

5.2.10 This profit is allocated to shareholders as patronage earnings on the basis of volume supplied. It is distributed as follows:

- 20 % is paid in cash
- 80% is retained by the company towards the payment of these patronage shares.

5.2.11 The company estimates that the average supplier will take 12 years to fully pay up his patronage shares. If production increases at a rate greater than 8% pa, they would never be fully paid up.

5.2.12 Once the patronage shares are fully paid up and the supplier reaches his equity target, he receives the full amount of the annual patronage earnings in cash.

5.2.13 Patronage shares can only be redeemed if the supplier:

- dies
- ceases trading with the co-op, in which case the repayment program covers a 12 year period
- can trade the shares to another supplier at a discounted rate
- reaches 75 and retires, in which case they are paid out as a lump sum.

5.2.14 It seems to me to be one way the company can retain profits for growth, but recognise each suppliers contribution to that growth so that he can eventually cash it in when he retires.

5.2.15 **Dairy Developments**
Another very interesting aspect of this co-op, was it's apparent willingness to assist farmers to expand and grow their business.

5.2.16 Not only did it offer a heifer leasing and equipment financing service, record keeping and advisory services, but they also had a special section set up within the company called Dairy Developments. This section has 15 staff devoted to providing producers with "dependable, reliable and objective information on the most viable route to achieve expansion goals".

5.2.17 To date they have helped over 100 suppliers on a one-on-one basis to expand and modernise their operations. It is a user pays service ($130/hour) and involves quite a structured process:

- Phase 1 Strategic planning
- 2 Operational planning
- 3 Site development and design
- 4 Bid and loan securement

- 5 Construction
- 6 Management implementation
- 7 Consultation and monitoring business management

5.2.18 A full program involves profitability and cash flow budgets, financing plans, investment analysis, labour models, animal flow models, waste disposal plans, etc. This group of people manages the whole project with emphasis on communication, expectations and updates as the project proceeds.

5.2.19 I visited one of their success stories that had been through this program and had increased their herd size from 40 cows to 450 cows. They were feeling much more confident about their future.

5.2.20 This section currently had 25 expansion projects in progress ranging from 100 – 1,200 cow herds and two years ago was made available to suppliers of other organisations.

5.2.21 **Governance**
The co-ops Board comprised of 24 directors elected by the members for a 4 year term. The age limit was 70 and a director could only serve a maximum of 4 terms.

5.2.22 Farmers also elected regional delegates to attend regional meetings and also to vote on behalf of regional farmers at the AGM.

5.2.23 Farmers were able to attend and vote at the AGM themselves if they wished, but due to the large travelling distances involved in attending these meetings, these regional representatives were seen as one way of enabling all members to have the opportunity to express their views and a vote.

5.2.24 **Impressions**
This company is also very farmer focused. They seem to be proactive in helping their members continue in the industry. Their communications in terms of written documentation to suppliers was very commendable – clear, concise and honest.

5.2.25 The few farmers I met seemed to really appreciate the company's efforts in this regard.

5.2.26 Also, the concept of "patronage shares" being issued effectively out of retained earnings appeared to give members a real sense of ownership and contribution.

5.3 Dairy Farmers of America

5.3.1 This co-op was formed in January 1998 by the merger (after 18 months of negotiations) of 4 existing co-ops. It has 22,000 farmers in 43 states and will collect 23% of the total milk produced in the US. Total turnover of the merged company is more than NZ$16 billion.

5.3.2 The merger was driven by low milk price, poor profits and declining farmer numbers. It has achieved huge economies of scale by:
- reducing duplication in labour inputs and administration overheads (1,000 jobs have so far been dissolved with an estimated saving of US$40 million)
- improving use of under-utilised manufacturing capacity and plant facilities (13 cheese plants have been closed since the merger)
- more efficient cartage of milk to those facilities

5.3.3 The merged company believes they now have the opportunity to market and promote milk more effectively by working together, instead of competing against each other. Also, their critical mass will give them increased bargaining power in the market place.

5.3.4 The co-ops main focus to date has been cheese and liquid milk but their future goal is to develop more value added products with a view to supplying into the export market.

5.3.5 They also wish to continue to develop their strategy of establishing joint venture operations with both customers and competitors in an attempt to continue to grow their business.

5.3.6 This company has a similar approach to governance as Land O' Lakes although their aim was to operate a Board of directors numbering 36 with monthly meetings to be held in Kansas. When I was there in July, the Board still included all the directors from the merged co-ops and totalled 104 in all.

5.3.7 DFA also requires its shareholders to purchase patronage shares out of retained profits. The current share requirement is US$1.75/100 lbs milk (NZ$0.94/kg milksolids). 20% of profits are distributed to members in cash with the balance being used to fund these patronage shares.

5.3.8 Patronage shares do not earn a dividend – they simply secure a producer's right to supply the co-op.

5.3.9 These shares are only redeemable on death or retirement and the repayment plan covers a 10 year period.

5.3.10 This co-op was still very new and obviously still determining a lot of the structures and guidelines under which it would operate in the future.

5.3.11 The most significant point of interest was simply its sheer size and the reasons the management and members felt this size was necessary.

6. Summary Impressions

6.1 Corporate Dairy Companies

6.1.1 The perceived benefits of ***plcs*** seem to include:

- an extra ability to raise capital, particularly equity capital, and so further the growth of the business
- the rules and regulations of the Stock Exchange demand higher reporting standards than farmer directors would normally demand
- the increased pressure on management and directors to be accountable to shareholders and to explain strategy to them, sharpens their performance
- there is more willingness and ability to reward executives with higher salaries and/or share option schemes
- share option schemes can also be provided for employees as an incentive to encourage good performance
- tradable shares enables farmers to "unlock" and identify the market value of their share of the investment in the industry

6.1.2 On the other hand, the disadvantages of ***plcs*** include:

- there is huge potential for farmers to lose control and market power within their company as their shareholding falls below 50%. They risk losing their sense of ownership and their ability to influence the future direction of their business
- as this happens, farmers cannot be certain how long the company will stay farmer friendly in terms of milk price. This is even more relevant if there is no co-operative competing for milk supply in the market place and setting a benchmark milk price
- as pressure comes on from shareholders to increase dividends, particularly in years when returns have been poor, management will only be able to achieve this by reducing costs, including the cost of milk. In a corporate company, profit and dividends are paramount.

- growing a business as a ***plc*** will often involve investing in higher margin activities and /or large business acquisitions. This may mean the business loses it's farmer/milk focus
- a shareholder farmers income stream will rely upon three things; milk price + dividend flow + capital growth in share values. But as share price increases, younger people will not be able to afford to buy the shares and their income stream will be limited to milk price. They will not enjoy some of the more significant benefits of the ***plc*** enjoyed by their forefathers
- as a ***plc*** grows, it can become more attractive and susceptible to takeover propositions by multi-nationals

6.1.3 Not all ***plcs*** succeed. It seems to me that most business success is not necessarily dependent upon structure, but more on the vision of top management and their ability to communicate that vision to the shareholders and translate it into positive action.

6.1.4 There are other alternatives to raising capital and "unlocking" a member's investment in the industry that a co-operative can employ before it needs to convert to a ***plc.***

6.2 Co-operatives

6.2.1 It is important to remember what gave rise to the co-operative in the first place – a need that no one else was willing to fill.

6.2.2 To forget this will see farmers embark on the circular trip, as they have done in England, of abandoning the co-op for the promised spoils of the corporate, only to find that, unless they are one of the "cherries", the corporate will abandon them just as quickly. They could be left with no secure market for their milk and no ownership of the processing capacity of their industry – no control!

6.2.3 Co-operatives can be just as successful as corporates and this can be demonstrated by the fact that some of the largest dairy companies in the world are 100% farmer owned co-operatives.

6.2.4 A successful co-operative simply needs much the same as a successful corporate:
- a leader with vision and strategy
- a management team with the skills and ability to implement that strategy and translate it into action
- shareholders who retain a sense of pride and ownership in their business and who are ultimately willing to continue to invest in that business through retained profits
- a clear and transparent basis for measuring performance, other than just milk price
- a willingness for management to be held accountable and to be rewarded according to performance

6.2.5 Because it is a co-operative, success will also depend upon the shareholders:
- being willing to continue to share the cost of initiatives that are for the "industry good"
- being willing to continue to embrace the co-operative spirit that sees all members able to share returns equally, regardless of size or location. These two principles are important as they maintain unity within the co-op and therefore critical mass
- and management working together towards a common goal of business growth, both on farm and in the market place
- and management willing to share knowledge and responsibility for what is supplied into the market place. A farmer's job is not finished at the farm gate just as the company's job does not begin with the tanker. All shareholders and employees must embrace the "cow to customer" philosophy.

Part 3 – Future Issues For the New Zealand Dairy Industry

7. The European Union and CAP

7.1 History

7.1.1 The Common Agricultural Policy was introduced in 1957 to increase agricultural production in order to guarantee a stable food supply (at least self-sufficiency) at reasonable prices for EU consumers, to stabilise markets, to ensure a fair standard of living for the rural population and to prevent the depopulation of rural areas.

7.1.2 Originally, it was a system of price support mechanisms and direct aid payments to producers designed to encourage increased levels of production. These take the form of export subsidies, import levies and guaranteed minimum prices for products supported by intervention buying and direct payments to producers based on the number of animals farmed or the number of acres cultivated.

7.1.3 The system has been too successful and by the mid 80s, Europe was suffering severe problems with over production and commodity surpluses. This saw the introduction of production quotas in order to discourage over production through a system of penalties for over-quota production levels.

7.1.4 In addition to this, the intensive farming practices stimulated by market support price measures had a seriously negative impact on the environment in terms of water pollution, soil erosion, deforestation, and wild life. The European Commission has since introduced environmental and structural payments to improve farm structures and profitability and to encourage environmentally friendly farming practices. Grants are available for conservation, reduction of farm pollution, reduced use of nitrogen, woodland planting, country stewardship schemes and employment incentives.

7.1.5 The effect of CAP on world markets has been to depress world commodity prices through subsidised exports of surpluses and protection of internal European markets. Without CAP, agricultural production in Europe would be lower and therefore world prices would be higher as supply more closely matched demand.

7.2 Reform

7.2.1 However, as a result of GATT, The European Union is committed to increasing market access for agricultural products and to reducing export subsidies over a 6 year period commencing in 1996.

7.2.2 In addition to this, the planned enlargement of the EU to include several Eastern European countries with significant potential to increase agricultural production is forcing member countries to seriously consider further CAP reform. The cost to the EU of maintaining the present system of production and price support measures once the Eastern European countries are admitted is expected to be too great.

7.2.3 The proposed reform package is designed to be more market driven and increase the competitiveness of EU agriculture while at the same time focussing on food safety and quality, and environmental issues.

7.2.4 The reform package contained in the Agenda 2000 proposals released in March 1998 involved, for the dairy sector:

- a 15% reduction in price supports for products
- this to be offset by a direct headage payment per cow

- plus a 2% increase in quotas, although this increase will not be evenly allocated to all farmers, only selected areas considered to be more " in need" of assistance such as hill country farmers and the young.

7.2.5 The intention is that reduced price supports will translate through to lower consumer prices at supermarket level and that these lower prices will stimulate increases consumption. This increased consumption will then be supplied by the increased production generated by increased quota levels. However, given the tendency for supermarkets to simply retain the higher margins themselves, it is doubtful in my view that this will happen.

7.2.6 There is also talk that quotas will eventually be removed altogether as more production-related subsidies are replaced by direct aid and environmental payments in an attempt to make EU agriculture more market competitive. Some in the UK suggested that this could be as soon as the year 2000 but the general feeling in Brussels was that it is more likely to be between 2003 and 2006.

7.2 Warning

7.3.1 I met many farmers in the UK and Ireland who would welcome this with open arms as they see quotas as stifling the opportunity for them to be innovative and grow their business. They are already planning to increase production as soon as this happens to take advantage of genetic and technological gains since quotas were introduced in 1984.

7.3.2 This, together with the huge potential for increased production in places like Hungary and Poland as their economies and infrastructures develop with the aid they receive from the EU, could create serious problems for dairy farmers in New Zealand.

7.3.3 In my view, there could be a 2-3 year period where European farmers increase production so significantly that massive surpluses of dairy commodities will accrue, further reducing world prices. As prices reduce, many farmers will attempt to improve profitability by increasing production, which will exacerbate the problem. It may take 2-3 years for production levels in the EU to reduce (via declining farmer numbers) to an equilibrium where supply equals demand.

7.3.4 Unfortunately, as world prices reduce, this will impact on returns for New Zealand farmers and more of them may also be forced to exit the industry. I hope I am wrong.

7.3 Future Payments

7.4.1 In any event, there is no doubt that the EU will continue to pay farmers to stay on the land. These payments will be less production based and more environmental and socially based. It surprised me, in the UK, how much the general public is prepared to pay to keep farmers on the land. The general population wants to keep the countryside looking "pretty" and they want to be able to go and roam in the countryside at their leisure – so they are willing to pay for that privilege.

7.4.2 It also surprised me how willing people in the UK were to allow Eastern European countries to join the EU. In my view, this enlargement process will not only increase the UK taxpayer contributions to the EU (the UK is a net contributor to CAP and pays more into EU funds than it receives), but also increase competition for the UK producer.

7.4.3 However, most people I spoke to believed the benefits of political stability and a potentially increased market as consumer wealth in these countries improved, more than offset these costs.

8. The International Marketplace

8.1 The Success of The New Zealand Dairy Board.

8.1.1 There is no doubt that the performance and achievements of the New Zealand Dairy Board is highly regarded and well respected among our international competitors. Each company I visited spoke of them in almost revered terms; some openly admitted they did not enjoy meeting them in the marketplace and avoided it if possible; others obviously set goals and had ambitions of displacing them from the number 1 spot in the market.

8.1.2 All of them were acutely aware of the present restructuring process in New Zealand and hoping that it would result in the eventual self-destruction of the Board.

8.1.3 Similarly, the environment in which the Board operates internationally, especially in Europe, is going to get tougher and meaner as European dairy companies fight to protect markets within their boundaries. We may have won the "spreadable butter case" but there will be more of these situations and our Board will need to be squeaky clean if it is to maintain it's current market position in Europe. This observation was reinforced by the Marketing Manager at Anchor Foods in Swindon.

8.1.4 I also attended a conference at Reading University, near London, on Future Markets For Milk and Milk Products and Implication for the UK Dairy Industry. The topics included issues such as developing export markets, branding, niche marketing and adding value among other things. Here again the success of the New Zealand Dairy Board was mentioned several times. BUT, each time, the speaker would make a very pointed comment about the barbaric animal welfare practices in New Zealand (see notes later).

8.2 The Power Of the Supermarkets

8.2.1 Almost 60 % of the food retail sector in the UK is controlled by 7 big supermarket chains – Sainsbury, TESCO, ASDA, Safeway, Co-op, Somerfield and Kwik Save. While I was in the UK there was speculation that these 7 would drop to 3 or 4 as some of these organisations merged in order to build critical mass in the market place.

8.2.2 They provide the direct link between the consumer and the food processor and have built up an awesome degree of power in the market place. This power is based not only on size but also on the consumer's willingness to "trust" them as providers of a wide range of safe, quality products supported by customer service and reliable brands.

8.2.3 Unlike here in New Zealand, a supermarkets "own brand" product is very highly regarded and sold as a premium quality product. A supermarkets own brand product offers some of the stiffest competition on the supermarket shelf.

8.2.4 In addition to this, supermarkets are very aware of the value of shelf space and food processors must pay huge amounts to secure premium shelf space from which to display and sell their products in the supermarket. Of course, "own brand" products will always be allocated the prime shelf space.

8.2.5 These organisations are also acutely aware of the savings to be achieved by maintaining minimum levels of stock on their premises and have shifted a huge amount of the responsibility for stock control onto the food processors.

8.2.6 When we visited Anchor Foods in Swindon, the team there described how their stock management system was critical to maintaining access to the supermarkets. Yellow fats generally only have 56 days before their quality begins to deteriorate. Of this 56 days, it takes 5 days to chill the product and run the quality control program. All supermarkets demand at least 35 days shelf life, so that means that Anchor Foods only has a maximum of 16 days stock to manage the supply demands of its big customers. Therefore, they must run a very tight stock control program, as ability to supply on demand is often all that distinguishes one supplier from another. Competition is so fierce that if one supplier can't meet a customer's demands, they may lose their business indefinitely.

8.2.7 Competition between these organisations is also very tough. They require quality, premium products to differentiate their business from that of other supermarkets. They are all acutely aware of the consumers increasing concerns about food safety, animal welfare and environmental issues. The hysteria caused by BSE, together with outbreaks of Salmonella and Ecoli has resulted in consumers questioning the impact of the food producer's management systems on all these areas.

8.2.8 In recognition of this, supermarkets are demanding that more and more of the products they sell are supported by full quality assurance programs that not only traces where the product has come from but also how it has been produced. Food processors are passing a lot of this responsibility onto the producer and requiring extremely high standards and onerous systems of proof of compliance. One farmer I met claimed his dairy hygiene inspection report was 40 pages long!

8.2.9 All this is adding time and cost onto the producer and usually for no extra increase in returns. He must comply with these demands simply to be able to continue to supply.

8.2.10 English farmers have been put under severe pressure by these demands and increased costs. They must comply, as they are so close to the UK consumer, compared with producers of imported goods. They become the "window" by which all food production is judged. They are therefore very adamant that supermarkets should be forced to :

- buy British first
- require the same standards and proof of quality from all producers, both foreign and local.

8.2.11 Since I arrived home, there has been evidence of the success they have had with their lobbying in that ASDA have banned the sale of New Zealand lamb in support of the "Buy British" campaign. Marks and Spencers also reviewed their orders of this product with a view to reducing the quantity sold.

8.2.12 The warning here is that this need for traceability and demand for higher and higher standards of production is going to impact more on New Zealand farmers if we wish to continue to export produce to mature markets such as the UK, Europe and the USA.

8.2.13 What we need to do, in my view, is be proactive in this area so that the improvements to quality actually add value to the product. There is little point in resisting this change, only to have supermarket buyers demand standards that border on the ridiculous (eg planter boxes outside the dairy shed.) It is better to work with the customer to reach mutual agreement on quality standards that are reasonable and practical rather than have them impose quality standards that are costly and add nothing to the value of the product to the consumer.

8.2.14 We also need to be proactive in educating the consumer about the way we produce food. It is not healthy for the consumer to believe that all animals can be treated as cuddly pets as this creates an unrealistic perception and expectation of what a producing farm animal is.

8.2.15 We must be careful how we promote our clean and green image. The power of the media is profound. We cannot afford to let a competitor, an angry consumer or a well-intentioned activist destroy our place in the market by publicly refuting some of our claims of "clean and green" with visual evidence to the contrary.

8.2.16 Again, when we visited Anchor Foods, we were told about a situation the Dairy Board had to manage to avoid an English consumer going to the media with video footage of cows with docked tails. This incident occurred shortly after the launching of an Anchor Foods advertising campaign based on "free range" butter and according to the Marketing Manager there, could have been devastating to sales at that time.

8.2.17 All of these reasons are why it is so very hard to develop and succeed with consumer products in the market place. It is extremely expensive to develop a successful brand and buy the shelf space necessary to ensure it maintains its place in the market.

8.2.18 It is easy to understand then, why a lot of the NZDB's effort in the USA goes into building successful relationships with both competitors and food processing customers, supplying key ingredients for consumer products. This strategy means that not only is the NZDB's business anonymous, (ie no mention on the food label of NZDB) which provides some safety from competition, but also the considerable cost of retailing the product is borne by the food processor. Examples of this type of business are protein ingredients for the nutrition food sector, cheese flavourings for sauces, dips and soups.

8.3 Animal Welfare

8.3.1 From what I saw on my travels, animal welfare is largely about perception. Those producers who do the best job of educating consumers about how and why animals are managed in their farming operations are the producers who will survive as suppliers to these consumers.

8.3.2 It seemed ironic to me that English farmers can keep their animals indoors in small concrete floored cubicles where their tails hang over the edge onto muck-covered floors and yet criticise Kiwi farmers for their barbaric practices. However, that is perception as they are able to convince the consumer that it is better to do this than to let the animals graze outside when it is cold and wet. (Admittedly there are times and places in the UK where this is true, but I don't believe that it needs to be for 6 months and certainly there are some farmers who keep their animals indoors all year.)

8.3.3 Some of the practices that I heard New Zealand dairy farmers criticised for included:

- tail docking
- inductions (even though the alternative for an empty cow is culling)
- dehorning calves without anaesthetic
- winter strip grazing systems (some English farmers and consumers are told we make our cows graze so hard in the winter, they are forced to eat dirt and calve in paddocks of mud)
- lack of shelter from heat, wind and rain
- distances walked to/from the dairyshed
- leaving dead stock and bobby calves on the side of the road for collection
- transportation of heavily in calf cows

8.3.4 I acknowledge that all of these practices are done for good reason and some of them form the basis of our successful, low cost dairying system. However, it is important in my view that we do a lot more to make them more acceptable (or less visible) to the public if we want to protect our business from unwanted media attention, and perhaps consequential loss of markets.

8.3.5 For example, perhaps farmers could be encouraged not to dock all cows tails by offering a premium for their milk based on the % of the herd that is undocked. There are a number of farmers who manage to minimise docking by simply trimming the tail hair periodically.

8.3.6 Perhaps we could change "inductions" to "advancement" and restrict the period of time that a calving can be brought forward to say 3 weeks.

8.3.7 Planting of hedges and shelterbelts, particularly on road frontages would also deflect some of the criticism.

8.3.8 Arranging for the collection of dead stock from up the tanker track, rather than from the roadside, would also avoid some of this criticism. We had some Irish visitors in September, and while their views on animal welfare are not as extreme as some of the English farmers I met, they were appalled by the sight of trailer loads of slink calves waiting to be collected on the roadside. Perhaps these trailers could be left in less conspicuous places.

8.3.9 The most interesting thing for me was that the issue of animal welfare is extremely important to the supermarkets trying to compete for the consumer dollar. Important that is, if price is relatively equal. Ultimately, however, **price** is the most important issue.

8.3.10 This was brought home to me just before I left England. The pig industry (and the poultry industry) has been under extreme pressure to improve their animal welfare standards. From 1 January 1999, it was to become illegal to tether pigs (permanently tie them up in pens) as this was just not acceptable to the consumer.

8.3.11 My host farmer, whose pig farms ran 2700 sows and comprised ¾ of his business, had spent many thousands of pounds upgrading his indoor pig units to comply with this requirement and ensure that animal welfare standards were complied with.

8.3.12 Just as I left in June, however, he received advice from his marketing organisation, that unless he was prepared to drop the price of his weaner pigs by 1 pound per pig, the supermarkets would be sourcing their pork from Denmark. In Denmark, it is not illegal to tether pigs and most units still operate this system. But because there is such an oversupply of Danish pigs on the market, they are cheaper than British pigs.

8.3.13 For this particular farm, selling 60-70,000 weaners pa, a price drop of 1 pound represented a significant drop in revenue and came on top of earlier price reductions of almost 5 pounds per pig, due simply to the value of the British pound and domestic oversupply issues.

8.3.14 At the moment, despite spending a huge amount of money to comply with consumers' demands about animal welfare, this farmer is selling weaners at a 30% loss, just to stay in the market.

8.3.15 **PRICE** comes first, then quality encompassing issues of food safety, animal welfare and the environment.

8.3.16 It is not too hard to understand then, why the UK farmer is lobbying hard to get the government and supermarkets to "Buy British". If they are successful, the only chance we will have of protecting this market is if we are able to prove that out standards are as high as theirs.

8.3.17 Also, it is easy to see that, while supermarkets have so much power, as producers we must work with them to ensure that we are the preferred supplier, both in price and quality.

8.4 Scale

8.4.1 It became very clear to me as I travelled that many organisations, both at the food processing level and the food retail sector, recognised that **SIZE IS POWER**. Their future existence depends upon maximising profits by:

- reducing duplication of effort and more efficiently using resources

- merging smaller organisations to work together rather than competing against each other in the market place
- building a critical mass better able to negotiate with suppliers and retailers, and to withstand adversity and the ruthless competition that occurs in the market place.

8.4.2 These organisations were actively pursuing this strategy of building a power base by merging with or acquiring businesses that could:

- expand their product range to include higher margin products
- provide access to more lucrative markets
- increase market opportunities, particularly outside their domestic market.

8.4.3 Some were actively involved in joint ventures with "offshore competitors". Geographical boundaries were no longer perceived as a barrier to business growth strategies.

8.4.4 Nearly every dairy company I visited believed that as Government support for their industry was reduced, there would be a greater need to expand their business offshore, not only to source product but also to sell product. They were generally looking to expand into similar markets as New Zealand – South East Asia, South America, Africa, Japan and China.

8.4.5 The processing and marketing sectors of the New Zealand dairy industry must be aware of this trend. **SIZE IS POWER.** Critical mass is essential if we are to continue to compete for markets against some of these organisations. Our industry also needs **SIZE** and given that we are small in global terms, we too need to be building relationships offshore to generate size.

8.4.6 This philosophy that scale of operation is the key to future profits has also filtered through to many producers on their farms. As mentioned earlier, the average herd size in Northern California is 3,000 cows. In the UK and Ireland, I visited several farms where the herd size was 300-400 cows. Some of these farms were even operating a largely pasture based system where the cost of production was down as low as 8 pence per litre.(This is approximately equivalent to the gross milk payout received by New Zealand farmers.)

8.4.7 While it may seem that these farms still have a long way to go to achieve the low production costs recognised in New Zealand, it occurred to me that these farms have grown in size over a relatively short time. If this rate of growth in farm size continues, and these businesses are able to spread more costs over more litres of milk, they may be able to achieve high volumes of production at comparable costs sooner than we think.

8.4.8 It would be a mistake therefore, for New Zealand dairy farmers to believe that as world trade in dairy products is freed up and demand is increased, we will be inundated with demand for product and prices will soar.

8.4.9 Price is the major determinant of demand. If we cannot compete on price, we simply cannot compete! We must not be complacent about our position as low cost dairy producers – there are many farmers in both the UK and the USA striving to be low cost producers by building the scale of their operation. There is also considerable scope for large scale dairying in Hungary and Poland.

8.4.10 Many farmers in New Zealand have recognised that scale is a significant factor when it comes to profitability and there is no doubt in my mind that this is the way of the future.

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