

Nuffield Scholarship Report

**Retaining Co-operative
Characteristics Amid Globalisation**

**Catherine Bull
1999**

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Table of Contents

1	Introduction	1
2	Conclusions.....	3
	2.1 Key Difference Between Co-operative and Conventional Dairy Companies.....	3
	2.2 Co-operatives Have Distinguishing Characteristics.....	3
	2.3 Experience of Case Study Companies.....	4
	2.4 Learning for the New Zealand Environment.....	6
3	Report Summary	9
	3.1 Globalising Dairy Market.....	9
	3.2 Priority Functions of Dairy Co-operatives.....	9
	3.3 Distinguishing Characteristics of Dairy Co-operatives.....	9
	3.4 Co-operatives Realities Pose Challenges	10
	3.5 Solutions to Retain Co-operative Member Commitment	13
	3.6 Solution to Achieve Critical Mass.....	14
4	Zwanenberg's Model for Modern Dairy Co-operatives.....	25
	4.1 Introduction	25
	4.2 Rapidly Changing Dairy Market	26
	4.3 The Rationale for Dairy Co-operatives Originates at the Farm ..	27
	4.4 Unique Characteristics of the Co-operative Company	29
	4.5 Is the Co-operative the Best Alternative for Dairy Farmers?	33
	4.6 Is it Possible to have 'the Best of Both Worlds'?	34
	4.7 Is Zwanenberg's Model Appropriate for Fonterra Co-operative Group?	38

5	The Netherlands.....	43
5.1	Netherlands Dairy Industry	43
5.2	Campina Melkunie.....	46
5.3	Friesland Coberco Dairy Foods	56
5.4	Summary of Friesland Coberco	65
6	Ireland.....	67
6.1	Background	67
6.2	Kerry Group “The Irish Model” – A Case Study	70
6.3	Three Irish Co-operatives Adopt the ‘Kerry Model’	85
6.4	Comparison of Kerry Group, Glanbia and Golden Vale plc’s.....	91
6.5	An Irish Perspective on the New Zealand Dairy Industry.....	95
6.6	Conclusions	96
7	References	99
	Appendix I.....	101
	Comments from Zwanenberg	101
	Appendix II.....	105
	The Kerry Way.....	105

Figures

Figure 1: Zwanenberg's Model for Modern Co-operatives	35
Figure 2: Campina Melkunie Representation & Governance	48
Figure 3: Friesland Coberco Representation and Governance	58
Figure 4: Friesland Coberco Capital Structure	63
Figure 5: Kerry Group Structure and Ownership (1999).....	80
Figure 6 Kerry Group Turnover 1974–2000	81
Figure 7: Golden Vale Plc Structure and Ownership	88

Tables

Table 1: Kerry Co-op Performance 1974 – 1978 Period of Early Growth	71
Table 2: Kerry Co-op Performance 1979–1985 Period of Diversification and Acquisitions.....	74
Table 3: The Float October 1986	77
Table 4: Kerry Co-op Ownership and Value in Kerry Group	79
Table 5: Turnover, Operating Profits and Operating Margins by Sector, 1998.....	91
Table 6: Share Value Performance by Company.....	94

1 Introduction

The dairy market environment is changing rapidly as the millennium trend of “globalisation” intensifies competition and rationalisation of both buyers and sellers. Acquiring critical mass in terms of milk and capital is necessary for dairy companies to successfully compete in the globalising market.

Dairy co-operatives worldwide are grappling with finding solutions to achieve critical mass. Given that dairy co-operatives have evolved to meet the needs of their supplying members, it is essential that the co-operatives ‘reason for being’ is not compromised or destroyed by solutions to acquire critical mass. It is also essential that the co-operative is able to remain viable and competitive as a processing and marketing company operating in a globalising dairy market. To fail will lead to falling returns and ultimately the demise of the co-operative.

Critics claim that limiting the supply of capital to that from members’ compulsory contributions and retentions constrains the co-operative. Members themselves also question whether it is the co-operative’s role to be involved in activities that do not directly relate to the collection, processing and marketing of their milk.

New Zealand’s dairy industry has been dominated by dairy co-operatives since 1936 when the single seller legislation was introduced. Deregulation means that farmers will have alternative supply options in the future. New Zealand dairy farmers have been geographically and historically isolated from the realities of supplying a co-operative versus a conventional company and often take the benefits of co-operative membership for granted.

New Zealand dairy farmers and our co-operatives also face unique challenges around restricted market access, a near-total reliance on exports and geographical isolation from the market place.

My report covers five European dairy companies that are fortunate to have unrestricted access to the European Union’s 360 million consumers. On the downside, European dairy farmers had milk growth restrictions imposed with the introduction of milk quotas in 1984. While European dairy farmers and companies face different challenges and opportunities, the co-operative purpose and characteristics are universal.

Many co-operatives are developing innovative solutions to achieve critical mass and retain members. Looking at the impacts and implications for the co-operative resulting from some of these initiatives provides some insight as to how similar proposals could affect Fonterra Co-operative Group.

Using case studies from Campina Melkunie Co-operative and Friesland Coberco Co-operative in the Netherlands, and Kerry Group, Glanbia plc and Golden Vale plc in Ireland, the objectives of this report are to:

1. Identify the differences between co-operative and conventional dairy companies.
2. Define the unique purpose and distinguishing characteristics of a co-operative.
3. Examine the experiences of the five dairy companies in terms of:
 - operating environment,
 - strategy and structure (organisational and capital),
 - the company's ability to meet its members' needs.
4. Relate learning to the New Zealand situation.

2 Conclusions

“Globalisation” is the strategy of the millennium. Acquiring critical mass in terms of milk and capital is necessary to be able to compete successfully in the globalising dairy market. To fail as a dairy company will lead to the demise of the co-operative, which is not in the interests of the members’.

2.1 Key Difference Between Co-operative and Conventional Dairy Companies

Given that dairy co-operatives exist to meet the needs of their milk supplying members, it is essential that the co-operatives ‘reason for being’ is not compromised or destroyed by solutions to acquire critical mass.

“Dairy farmers ‘invest’ their capital in dairy co-operatives to secure and enhance the investment in their individual dairy farm businesses. Farmers invest in processing and marketing to first, guarantee an outlet for their milk and second to maximise the payout for their milk and hence value of their dairy farm business. These are the two priority functions of a dairy co-operative.” Dr Adrie Zwanenberg, 1997.

2.2 Co-operatives Have Distinguishing Characteristics

- Members provide the capital and thereby own and control the co-operative, normally in proportion to milk supply.
- The co-operative company’s milk intake strategy guarantees an outlet for members’ milk.
- The ‘operating surplus’ is paid to members in proportion to milk supply, and is a combined return for milk supply and capital contribution.

Compromising these distinguishing co-operative characteristics undermines the co-operative’s purpose and inevitably leads to the co-operative failing to meet the needs of its farmer members.

Sourcing equity capital exclusively from co-operative members ensures that the co-operative continues to meet the needs and reflect the aspirations of milk supplying members. *“If the members are not in a position or not willing to provide the necessary risk-bearing capital for the processing and*

marketing of their own milk, then the dairy co-operative concerned does not have the right to exist". Zwanenberg 1997.

The co-operative is in the business of milk – guaranteeing an outlet and maximising the payout for members' milk. Members' provide equity capital to enable the co-operative 'company' to achieve these priority functions. The benefits of co-operative membership are distributed in proportion to milk supply, not in relation to provision of capital. The co-operative is not an investment company and members should not expect benefits as 'investors'. The real benefit to members is the co-operative's focus is on meeting their needs, thereby increasing the value of their individual farm businesses.

Focusing on maximising the return on capital provided by members, in the processing and marketing company in isolation is meaningless. While it offers transparency and accountability for 'company' performance, members ultimately judge their co-operative's performance on the value it delivers to their individual dairy farm businesses.

Members must judge performance in terms of serving the common interests of its members, namely adding value to farmer members' milk and reducing their input costs. This should be stated in the co-operative's mission and direct the entire focus of the Board, the management team and farmer shareholders.

2.3 Experience of Case Study Companies

"Delinking" (separating the supply of capital from the supply of milk) and "sourcing outside capital" are euphemisms for "selling" parts or all of the co-operative to vested-interest investors whose sole focus is profit, dividend and share appreciation.

Sourcing investor capital whether voluntarily from members or externally from the stock exchange irrevocably destroys the purpose, priorities and characteristics of a dairy co-operative. Investor capital alters the operating surplus determination and distribution characteristics of a co-operative; a distinction is made between milk price and return on investment, milk is treated as an input with members' milk price determined by 'the market' and the resulting operating surplus is distributed as a variable dividend to investor shareholders.

The co-operative becomes an 'investment company' focused on meeting the dividend and share appreciation expectations of investor shareholders. These are in direct conflict with the 'guaranteed outlet and maximise payout for milk' priorities of co-operative members, which become of secondary importance.

Separating the co-operative's primary processing (commodity) activities and the value adding activities and creating an investment vehicle for the latter destroys the co-operative:

1. The value-adding plc will only source the milk it needs to maximise profit, thereby restricting the proportion of members' milk going into value-added products. The co-operative obligation to process all members' milk into the most profitable product mix does not apply in this structure.
2. The potential to earn a better milk price from value-adding activities will be out of co-operative members' control and the 'profit' from such activities will be distributed to investor shareholders.
3. The co-operative is confined to capital intensive, low value, low margin commodity processing and trading.

Additional pitfalls experienced by the Irish mixed co-operative/publicly listed company structures are:

- Selling shares in the company to 'investors' results in loss of member control and a drastic and irrevocable change in the co-operative's focus and purpose.
- Investor shareholders expectations are satisfied at the expense of supplying shareholders. Reducing milk price is a quick and easy solution to growing profitability
- The inevitable conflict between milk price and profit is exacerbated when the dominant raw material is milk and a significant proportion of earnings is related to low-margin activities. The pressure on milk price is extreme.
- Value is added to members' milk, but the associated operating margin/profit is distributed to investor shareholders in proportion to capital supplied. Milk supplying members receive a market-based milk price.
- A strategy of diversification via acquisitions is not a guaranteed route to profitability, growth and wealth creation (share appreciation).

- Rules that ensure that the co-operative retains the majority shareholding and control in the plc company are invariably changed. Subsequent floats further erode the co-operative's majority shareholding.

The plc can divest the milk collection and primary processing activities, which originally provided the launching pad for the investment company. One generation of farmers has 'cashed in' the ability to collectively add value to their milk. In the case of Kerry Group, the diversification strategy developed in response to growth constraints imposed by milk quota caps meant that it was no longer a dairy company (8% of profit is derived from milk).

If voluntary capital is sourced from members, a market-based return on voluntary capital will ensure that the co-operative's characteristics regarding determination and distribution of operating surplus are not compromised. Assigning voting power to voluntary capital is to be avoided to mitigate any possibility of investors influencing the co-operative's purpose or characteristics. Co-operatives are often tempted to create 'dry' (non-supplying) shareholding to retain the use of retiring shareholders capital. Providing voting power to dry shareholders as occurs in Kerry Co-operative, dilutes the common purpose, vested interest control held by milk supplying members.

Co-operative members must provide 100% of the equity capital for the collection, processing and marketing of their milk. Retaining member ownership and control of the dairy co-operative ensures that the co-operative focus's on and achieves its priority functions of guaranteeing an outlet for and maximising the payout for members' milk.

2.4 Learning for the New Zealand Environment

The New Zealand dairy industry has had a strategy of gaining critical mass and market access through joint ventures. Fonterra Co-operative Group owns joint venture recombining and value adding operations in target markets which overcomes the unique challenges of a near total reliance on exports, restricted market access, geographical isolation from export markets and the fact that milk is 86% water.

Consequently, increasing the value of Fonterra Co-operative members' milk is inextricably linked to using non-member milk in target markets. It follows that adopting a structure like that advocated by Zwanenberg defeats the purpose of Fonterra Co-operative Group's joint ventures and the co-operative priority of maximising the payout for members' milk. Joint

ventures provide significant advantages, opportunities and solutions given the unique New Zealand dairy industry situation.

In addition to being a source of ‘committed’ or ‘smart’ capital and local milk supplies, joint ventures provide ‘corporate citizen’ status and acceptability, knowledge and understanding of the local market, and increased market access for New Zealand sourced dairy product. *“To overcome market access restrictions and create the necessary market dominance for success, Fonterra must use non-member milk and become a corporate citizen of countries it wishes to have a presence in”*. (Warren Larsen, CEO of New Zealand Dairy Board 1991–2001).

Dr Zwanenberg has proposed a model for modern dairy co-operatives in a globalising dairy market. He strongly advocates retaining co-operative principles and developed his model in response to the needs and experiences of European co-operatives. The crux of Zwanenberg’s model is the distinction between the collection, processing and marketing of members’ milk, which is ring fenced within the co-operative, and of all of the other dairy and non-dairy activities, which are within the dairy plc. A linking co-operative holding company enables the co-operative to collect voluntary vested-interest capital from co-operative members to be added to its controlling investment holding company. This ensures that the co-operative retains the majority shareholding and influence in the dairy plc.

The European environment with milk quota caps and unrestricted access to the (expanding and wealthy) European Union consumer market is almost the reverse of the New Zealand situation. European companies regard the organic milk growth opportunities within New Zealand with envy. New Zealand also faces much greater restrictions on market access. While identifying a way forward for European co-operatives, Zwanenberg’s model is not appropriate for New Zealand.

Depending on definition, between 50% and 75% of Fonterra’s export product is sold as undifferentiated commodities. If Fonterra Co-operative Group were to adopt Zwanenberg’s model, the vast majority of co-operative members’ milk would be sold to the dairy plc at commodity prices. While Fonterra co-operative members would receive a dividend proportional to the capital provided by the co-operative through the holding company, they would have lost the opportunity to add value to their milk and thereby maximise payout. The value added to members’ milk would be distributed as a dividend or appreciating share value to all investing shareholders. New Zealand dairy farmer members would be largely confined to commodity trading.

“With strategic use of joint ventures, confining investments to adding value to members’ milk, and a maximum milk supply growth rate of between four and six percent per annum, Fonterra shareholders can and should fund future capital requirements.” (Warren Larsen)

The outside capital and non-member milk derived from joint ventures does provides the necessary critical mass and market access to ensure that Fonterra Co-operative Group can operate successfully in the globalising dairy market. However the ‘outside’ capital does not compromise the co-operative’s nature and characteristics.

3 Report Summary

3.1 Globalising Dairy Market

The dairy market environment is changing rapidly with the trend of “globalisation”. Acquiring critical mass in terms of milk and capital is necessary to be able to compete successfully in the globalising dairy market. This is resulting in intensifying competition and continuous rationalisation of both sellers and buyers. Dairy co-operatives worldwide are grappling with finding solutions to achieve critical mass. Given that dairy co-operatives have evolved to meet the needs of their supplying members, it is essential that the co-operatives ‘reason for being’ is not compromised or destroyed by solutions to acquire critical mass.

3.2 Priority Functions of Dairy Co-operatives

The rationale for co-operatives is driven by farm based technical and economic factors, not by emotion as frequently claimed by co-operative critics. Dairy farmers are motivated to invest in dairy co-operatives to secure and enhance the investment in their individual dairy farm businesses. Farmers invest in processing and marketing to first, guarantee an outlet for their milk and second to maximise the value of their milk and hence dairy farm business. Consequently, these are the two priority functions of a dairy co-operative.

3.3 Distinguishing Characteristics of Dairy Co-operatives

Comparing the characteristics of co-operatives and ‘conventional’ (private and publicly listed) companies highlights unique, distinguishing characteristics that specifically meet the needs of supplying shareholders and make a co-operative their best economic alternative.

While a dairy co-operative is as commercially focused on generating an operating surplus as conventional companies, a dairy co-operative is unique with respect to ownership, milk intake strategy and the determination and distribution of operating surplus. Ownership and control is by supplying members, normally in proportion to milk supply. The milk intake strategy is to purchase all milk produced by members thereby fulfilling the priority function of providing a secure outlet for members’ milk. Consequently a

co-operative is production driven by its purpose. Finally the 'operating surplus' is paid to members in proportion to milk supplied and includes a combined return for milk and capital supplied (payout).

In comparison, conventional dairy companies are owned and controlled by equity investors in proportion to the capital supplied. The milk intake strategy is determined by the market place, milk is costed as an input and the 'profit' is distributed to investors as a dividend or share value appreciation in proportion to the capital supplied. Conventional dairy companies only source the milk they require, and at the lowest cost possible in order to maximise profit. They have no interest in meeting the farm-based needs of milk suppliers beyond securing the raw milk requirements.

The unique characteristics of co-operatives result in some trade-offs and challenges for co-operative members, governors and management.

3.4 Co-operatives Realities Pose Challenges

3.4.1 The Co-operative is Not an Investment Company

Farmers make a joint decision to supply milk and capital to a co-operative. Capital is not 'invested' for the purpose of achieving a return on investment in processing and marketing in isolation. Farmers invest in the value adding chain to secure an outlet, and maximise payment for the farm produce, milk. Milk is the business of a dairy co-operative. Members provide capital to enable the co-operative to fulfil its purpose. The co-operative is not an investment company.

3.4.2 Distinguishing Between Milk Price and Return on Capital Creates Risk

Distinguishing between milk price and return on capital is arbitrary and meaningless in a co-operative. While it can drive performance transparency and accountability, differentiating between milk price and return on capital incorrectly assumes that milk and capital are supplied separately. An isolated focus on return on capital puts the fundamental co-operative characteristics at risk and frequently leads to the demise of the co-operative.

3.4.3 A Co-operative is Production Driven

A co-operative is production driven by its very purpose; that is guaranteeing an outlet for members' milk. A co-operatives first function is to accept all of its members' milk, and then it processes that milk into the most profitable product mix. The uncertainty and variability of members' milk supply leads

to less efficient plant utilisation and product mix, and variable product volumes for market. Consequently the co-operative inevitably achieves a lower 'operating surplus' than a market-driven conventional company could achieve operating with pre-determined supply contracts.

This is the price co-operative members' pay in return for a guaranteed outlet for their milk. If this price for milk delivery right is too high, the co-operative will lose members. The price of the delivery right is exacerbated in New Zealand where our milk supply varies depending on grass-growth and there are no restraints or quotas on production. However this is mitigated by the opportunity to produce milk from a low-cost system and to increase the production from and hence value of our individual farm businesses.

3.4.4 Co-operatives Can Not Financially 'Out-Perform' Conventional Companies

A conventional company identifies which products it will make the best margins from, decides how much it wants to produce and then sources a pre-determined milk supply.

Conventional companies are market-driven with supply contracts designed to secure a fixed volume of milk. 'Cherry-picking' or pre-determining a market niche and milk supply means conventional companies can pay a higher milk price than that paid by co-operatives and still be profitable. Unless a co-operative 'closes' or limits its milk supply, it is impossible to financially 'out-perform' a company that is market-driven.

3.4.5 Guaranteed Outlet a Key Performance Component

The performance feature delivered by co-operatives in guaranteeing an outlet for members' milk and thereby securing and enhancing the value of the farm business is a critical performance aspect that is the priority function of the co-operative. It is not available from a conventional company. Highlighting and promoting this performance aspect will ensure that the co-operative nature of the company is not undermined by management nor undervalued by members.

3.4.6 Co-operatives are Price Setters

Co-operatives set the milk price for conventional companies. Therefore contract suppliers to a conventional dairy company 'free-ride' on those farmers who support the co-operative. Supplying milk to conventional companies will be advantageous to the free riders in that they initially and invariably continue to, receive a price premium compared to the co-operative

members. However this price premium is invariably associated with supply contracts limited to a fixed term.

3.4.7 Predatory Pricing Tactics

Predatory pricing is used strategically by conventional companies to draw milk supply and capital away from the co-operative. As the co-operative is weakened, the payout falls allowing conventional companies to drop their milk price.

The weakening of the co-operative results in the milk price paid to every dairy farmer, whether supplying a co-operative or a conventional company, being depressed below what could have been earned. This reality is demonstrated by events following the deregulation of Milk Marque in the United Kingdom.

Following deregulation of Milk Marque in 1994, the conventional dairy companies used predatory pricing to cherry pick suppliers. Milk prices went from 22 pence per litre in 1994 to 26 pence per litre in 1995 and 1996. Farmers switched to contract supplying conventional companies for a price premium of half a penny a litre of milk. As one farmer put it “the co-operative spirit is half a penny deep”. In New Zealand terms, that would be equivalent to 10 cents per kilogram of milksolids at a \$4.50 payout. In England, farmer after farmer told me that they “could not afford to continue supplying the co-operative”. Milk Marque was left with the smaller and more isolated milk producers, which consequently resulted in further reductions in milk prices. In 1999, Milk Marque’s price was 18.5 pence per litre. As Milk Marque’s price fell, the conventional companies also dropped their milk price, but retained a price premium of between 0.5 and 1 penny per litre. Ultimately all dairy farmers received lower milk prices and the conventional companies gained better margins. As the conventional companies achieved the milk volumes they required, the price premiums reduced and they were more selective in renewing supply contracts. Many farmers also experienced losing the outlet for their milk; sometimes the notice period was measured in days.

New Zealand’s dairy industry has been dominated by dairy co-operatives since 1936 when the single seller legislation was introduced. Dairy farmers have had little choice but to supply the co-operative. With the formation of Fonterra Dairy Co-operative and the associated deregulation, it is likely that farmers will have alternative supply options besides the co-operative in the future. While other primary industries such as the apple and pear industry have provided some valuable lessons, New Zealand dairy farmers have been geographically and historically isolated from the realities of choosing between supplying a co-operative or a conventional company.

3.5 Solutions to Retain Co-operative Member Commitment

3.5.1 Member Education

A co-operatives success is dependent on the commitment and loyalty of members. Developing and retaining member commitment is a valuable and crucial achievement of a dairy co-operative. Unless dairy farmers understand and value the unique characteristics, benefits and trade-offs associated with co-operative membership, other alternatives will appear to be more attractive in the short term. Education increases farmer understanding of free riders, predatory pricing tactics and the economic benefits of co-operative membership.

3.5.2 Governance and Management Commitment to Maintaining Co-operative

It is equally important that the co-operative continues to understand and meet the needs and aspirations of the farmer members. Newly appointed executives and professional directors often have exclusive corporate experience and a limited understanding of the distinguishing characteristics and priority functions of a dairy co-operative that enable it to meet the needs and aspirations of the supplying owners. Educating such influential executives and governors is vital to ensure that responses to competitive pressures do not compromise the co-operative's priority functions, purpose and characteristics.

3.5.3 Achieving Member Support for Strategy

Openness and honesty in communicating the strategy is essential to obtain member understanding of and support for the strategy. Failure to achieve this will result in an exclusive focus on short-term payout and members will not be willing to invest in the longer-term benefits associated with the strategy. The cost to the co-operative will be insufficient retentions to implement the strategy, and ultimately the loss of members, milk supply and capital.

“If the [co-operative] members are not in a position or not willing to provide the necessary risk-bearing capital for the processing and marketing of their own milk, then the dairy co-operative does not have the right to exist.”
(Zwanenberg 1997.)

Campina Melkunie invests considerable resources and effort in communication, education and training, as a key to building member trust, loyalty and commitment to the co-operative. Historically, the directors and management demonstrated a ‘we know best’ approach. This proved costly

with member perception of a dictatorial approach resulting in the unwanted loss of members. Campina Melkunie now has a very simple communication policy: “always tell members the truth, even when it is not what they want to hear”. Board members and executives go to great lengths to explain the strategy and ensure that members agree with it. The benefits of belonging to a co-operative are promoted at every opportunity.

3.5.4 Delegation of Member Authority Speeds Up Decision Making

Co-operatives are often accused of cumbersome, slow, inefficient decision making. Friesland Coberco and Campina Melkunie have mitigated this with an electoral college for the appointment of representatives and governors. Farmer members vote for their area representatives only and have delegated their authority to representative bodies who are well informed and consulted on co-operative and business matters, and have genuine and significant influence and control.

3.5.5 Co-operative Initiatives to Achieve Critical Mass

From a co-operative members perspective it is also essential that the co-operative is able to remain viable and competitive as a processing and marketing company operating in a globalising dairy market. To fail will lead to the demise of the co-operative. Critical mass in terms of milk supply and capital provide necessary competitive advantage. Critics claim that limiting the supply of capital to members’ compulsory contributions and retentions constrains the co-operative. Members themselves also question whether it is the co-operatives role to be involved in activities that do not directly relate to the collection, processing and marketing of their milk.

3.6 Solution to Achieve Critical Mass

Many co-operatives are developing innovative solutions to achieve critical mass and commercial decision making. Looking at the impacts and implications for the co-operative resulting from some of these initiatives provides some insight as to how similar proposals could affect Fonterra.

3.6.1 Promote Commitment to Co-operative Philosophy

Campina Melkunie is totally committed to maintaining the co-operative philosophy and characteristics. It is promoting and using these to differentiate itself as an economic alternative for dairy farmers in order to retain and attract members. The structure and behaviour are designed to accommodate the needs of both the supplying members and the operating company.

The investment in communication, education and training are designed to build trust, commitment and loyalty to the co-operative, and to ensure members value and support the strategy rather than focus exclusively on payout.

3.6.2 Improved Decision Making

An effective communication strategy as outlined above, combined with an electoral college, the associated delegation of member authority and representative bodies with genuine and significant influence and control are designed to speed up and enable more informed decision making.

3.6.3 Increase Members Capital Contribution

Campina Melkunie's equity capital is provided by members. The permanent, non-allocated, general reserve accounts for 60% of the total equity (built up via retentions). Additional capital has been obtained from members.

Compulsory capital contributions ("members participation units") were proposed in 1991, but were rejected by members. Voluntary members participation units were subsequently introduced in 1998. They received a significant premium, but market based interest rate paid as a bonus above the normal milk price.

In keeping with the co-operative nature of the Company, Campina Melkunie assigned an arbitrary market based value to members' voluntary capital contributions. Given that the co-operative is in the business of milk, members provide capital as a means of adding value to their milk. If a distinction is going to be made between milk price and return on capital, the co-operative purpose, nature and characteristics will be retained if a market related return is paid for capital and the resulting operating surplus is distributed as the milk price.

In 2001 compulsory members participation units were successfully introduced to fund the strategy. New members also contribute their share to the collectively owned, permanent equity. Campina Melkunie began a policy of allocating any increases in equity to members in 1999 to minimise take-over risks.

3.6.4 International Co-operative Membership

International co-operative membership is an option for increasing the supply of capital and milk to achieve critical mass and market dominance without compromising the co-operative nature of the business.

Recent initiatives suggest that Campina Melkunie could selectively use international membership to acquire further critical mass necessary to achieve market dominance in target markets. Co-operative membership was offered to subsidiary Milchwerke Koln/Wuppertal (MKW) suppliers in Germany in 2000.

Denmark's MD Foods and Sweden's Arla Co-operative merged to form Arla Foods in 2000. EU competition legislation was not in place to accommodate a cross-country merger however this was legally overcome with a complex company structure.

3.6.5 Acquisitions

The mission statement: "*Campina Melkunie is an international co-operative enterprise specialising in the development, production, sale and distribution of dairy products*" emphasises the co-operative nature but does not restrict the business to members' dairy products.

The strategic priority is to increase the proportion of members' milk sold within the valuable, but intensely competitive European Union. Differentiation and increasing market share through brands and product development has resulted in the acquisition of subsidiaries in nearby target markets of Germany, Belgium and the United Kingdom. The introduction of compulsory capital contributions from members has provided the equity to fund these acquisitions. Many of these companies came with contract suppliers. As the contracts expire, renewal will depend on requirements not able to be met by Campina Melkunie's members' milk.

3.6.6 Voluntary Member Capital

Friesland Coberco has introduced voluntary member capital contribution or "choice", as it is referred to by New Zealand proponents. This has compromised the co-operative's purpose and distinguishing characteristics, possibly past the point of no return.

Friesland Coberco is making considerable structural changes in order to implement the growth strategy. Initiatives to increase critical mass in terms of market dominance and capital supply have resulted in changes to the

organisational and capital structures. The “structure follows strategy” management dictum is compromising the co-operative’s purpose and characteristics.

The co-operative (Seven Province Co-operative) is the sole shareholder of Friesland Coberco Dairy Foods Holding Company. The Holding Company’s business activities are carried out by eight operating companies organised within two operating subsidiaries: Friesland Coberco Dairy Foods and Friesland International.

Friesland Coberco has adopted a capital structure more akin to that of an investment company. Co-operative members have agreed to a change in capital structure that offers co-operative members the choice of voluntarily investing capital in the co-operative. In addition to (indirectly) generating equity capital for the Company, management believes that focusing on return on capital will result in commercial business drivers and decision making. Management motivation for promoting the change in performance focus from ‘milk price’ to ‘return on capital’ was that ‘milk price’ misdirected management decisions and the Company’s business performance was difficult to measure given the variables outside management control that impact on milk price. This change to a focus on ‘return on capital’ compromises the fundamental purpose of the dairy co-operative; namely to maximise the payout for members’ milk.

Voluntary capital is currently provided by current and retired co-operative members. These investor shareholders have no voting power so control remains vested with the milk supplying co-operative members. However the creation of ‘investor’ shareholders has also significantly altered the co-operative with respect to the determination and destination of the operating surplus. The milk price paid to members is based on that paid by five large Western European dairy co-operatives. Any resulting operating surplus is distributed to A (co-operative members) and B (investor certificate holders) shareholders as a return on capital.

The arbitrary assignment of a so-called ‘market milk price’ in order to determine a return on capital, has shifted the governance and management focus away from increasing the payout members receive for their milk to a focus on return on capital. Value is added to members’ milk, but for the benefit of investor shareholders.

The two attempts to raise voluntary capital from members failed to generate the anticipated capital. This result occurred in the European environment where dairy farm businesses have growth restrictions imposed by milk quotas. In New Zealand, where farmer members have the opportunity to increase their milk production, it could be even more difficult to source

voluntary capital from members. Friesland Coberco had to resort to institutional investors for subordinated loans. This finance option is more akin to a co-operative. That this option was not exhausted before introducing investor capital suggests that the restructuring was driven by a management agenda.

The rationale for Friesland Coberco's structure is that the company is able to achieve growth independently of members' businesses (i.e. compulsory capital contributions), providing greater flexibility and opportunity to raise capital, yet the members continue to influence the Company through the Co-operative's ownership.

Friesland Coberco is a co-operative in transition to becoming an investment company. The structure is in place and the risk for Friesland Coberco's co-operative members is that the company will source further capital from external investors. In September 1999 the Management Board proposed the introduction of external investor capital alongside a minimum co-operative shareholding of 51% in Friesland Coberco. To date (2002), the co-operative members have rejected such proposals. This highlights the contrasting aspirations that co-operative members and management have for the Company. Given the emphasis on return on investment and the associated restructuring, combined with management's desire for external investor capital, it will be difficult for members to regain the co-operative purpose and focus of maximising the payout for members milk.

3.6.7 Use of Investor Capital

The mixed co-operative/publicly listed company (plc) unique to the Irish dairy industry demonstrates that investors and dairy co-operative members can not achieve mutually beneficial synergies. Once a co-operative sources capital from external investors, effectively becoming an investment company, the focus and priority is to meet the expectations of investors. When a conflict of interest arises between milk price and profit, members and investors, the co-operative members need for a high milk price is secondary. The milk supplying shareholders have sold their co-operative and with it the ability and opportunity to increase the value of their milk and dairy farms through value adding activities.

Kerry Group

Kerry Co-operative invented the mixed co-operative/publicly listed company with stock exchange listing in 1986. Initially 20% of Kerry Group (plc) was floated on the stock exchange, with Kerry Co-operative retaining 80% ownership. Subsequent rule changes to the successive floats reduced the

co-operatives ownership to 35% in 1999. Company rules currently stipulate a minimum co-operative ownership of 20%.

Kerry Co-operative is still the majority shareholder. Holding the co-operative shares in a block maximises Kerry Co-operative's power and influence within the publicly listed company. However management's commitment to the founding farmers is the main source of farmer influence, i.e. in reality farmer influence is subject to management discretion and empathy.

The decision to list was management driven. Kerry Co-operative had experienced a challenging start-up financially, and the Irish economy was in a period of high inflation, high interest rates and a low Irish punt. From a management perspective, listing had a number of advantages: equity capital in this environment was less of a financial burden than debt; had the potential to generate large sums of capital; left management with total control and was seen as a key factor for the successful implementation of the rapid diversification strategy.

Kerry Group is a very successful investment company consistently increasing annual operating profits and share value by 15% each year. This equates to doubling turnover every five years. However Kerry Group is not a 'dairy' company. Less than 8% of turnover is derived from milk products. Kerry Group buys and processes more berry fruits than milk.

Listing was never intended to improve the payout for members' milk. The intention was to increase members' wealth, via appreciating share values. With the introduction of quotas, diversification into an international food business via an acquisitions strategy was seen as the antidote to the perceived stagnation associated with European dairy co-operatives and dairy farming. Kerry Co-operative had implemented a diversification strategy prior to listing, reducing the near total reliance on members' milk and gaining experience in identifying, purchasing and managing acquisitions.

Kerry Group has created considerable wealth for the original Kerry Co-operative members. Farmers purchased shares in 1986 for 35 pence and now (2002) they are worth over IR£12. In addition to the share appreciation and minor dividend payments, each successive float has resulted in co-operative owned plc shares being transferred to members. These 'sweeteners', combined with 'dry' (non milk supplying) co-operative members are credited with securing the necessary vote for successive floats.

Of the 6000 Kerry Co-operative members involved in the 1986 float, 30% were 'dry' shareholders. Dry shareholders have equal say within Kerry Co-operative. They had every incentive to support the floats. In 2002, only

one-third of the Co-operative members are currently active milk suppliers. The 'cost' of this capital is often greater than initially anticipated.

Kerry dairy farmers are increasingly losing control and influence of their co-operative, let alone the plc. The majority influence of 'dry' shareholders within Kerry Co-operative reinforces the risk and challenge to the common purpose, vested interest, milk producers co-operative that occurs when co-operative membership is extended to non milk producers.

The latest proposal to reduce the co-operatives ownership of Kerry Group to a minimum of 20% included an option for Kerry Co-operative to purchase the Agribusiness Division from Kerry Group. This includes the milk collection, primary processing, artificial insemination, the feed mill and a store network. This option is open to 2020. This option will result in Kerry Group plc divesting the dairy co-operative.

The recent takeover of Golden Vale plc has been interpreted by some Kerry suppliers as a commitment by Kerry Group to retain the Agribusiness subsidiary. Industry commentators and analysts predict that the Agribusiness Division including the Golden Vale Agribusiness activities, will be sold back to the members and merged with Dairygold Co-operative to form a Munster Co-operative comprising 70% of Ireland's milk pool. It is anticipated that Kerry Group would purchase and market selected dairy products. Resulting operating margins would be distributed to Kerry Group investors. The dairy co-operative would be left with the capital intensive, low margin collection and primary processing. Kerry Group would retain the higher margin, value adding activities for the benefit of investor shareholders.

Kerry Group's founding farmers have sold their ability to collectively add value to their milk in return for wealth creation opportunities. The co-operative provided the launching pad for the formation of a very successful investment company. If the Agribusiness Division is purchased by the co-operative, the dairy farmers will be back where they left-off 16 years ago and one generation of farmers will have had an opportunity for unprecedented wealth creation.

The attempts of three Irish co-operatives to emulate Kerry Group have proved unsuccessful. Initial stock exchange confidence and speculative share prices were achieved on the back of Kerry Groups success.

Kerry Co-operative had already embarked on a strategy of diversification out of low margin dairy commodities, into higher margin ingredients and consumer products prior to listing. Equity capital was used to accelerate the rate of diversification. In comparison, the co-operatives that followed Kerry

Group onto the stock exchange were largely low margin commodity traders with members' milk being the dominant raw material. Consequently a conflict of interest between milk price and profit emerged after five years and subsequently the pressure on milk price has been extreme.

Glanbia plc

Avonmore (1989) and Waterford (1989) plc's merged in 1996 to form Glanbia plc. By 1999 predicted merger savings and growth targets had not been achieved. This was largely attributed to poor management and weak decision making. Sweeteners offered as part of the merger deal were seen to be limiting the company's ability to realise the strategy and were broken. Acquisitions were on-sold at a loss.

Co-operative members' milk is the dominant raw material for Glanbia exacerbating the conflict between milk price and profit. Despite the dairy co-operative majority shareholding in Glanbia, the investment company reduced milk price as a means to appeasing the expectations of the investor shareholders and stock exchange. Reducing the milk price was a quick and easy solution to growing profitability and share value.

Golden Vale plc

Golden Vale listed on the stock exchange in 1990, but introduced a unique structure. The founding co-operative Golden Vale Food Products (GVFP) became a subsidiary of the plc and Golden Vale plc owns the subsequent acquisitions. Dairy farmer members' own plc shares individually rather than in a block. GVFP experience demonstrates that loss of ownership and accelerated loss of farmer control under a structure of individual ownership rather than block ownership.

The core and dominant business unit of Golden Vale plc is GVFP which in 1998 accounted for 44% of Golden Vale's turnover and generated a profit margin of 1% after paying an average Irish milk price. It is very difficult for a plc to meet investor expectations when such a high proportion of the turnover is in low profit margin activities. Golden Vale plc were investigating ways of divesting the co-operative in 1999. This came to a head in 2001 when Golden Vale milk suppliers gave notice of significant milk supply transfers to Tipperary and Dairygold co-operatives. Kerry Group made a successful takeover bid for the entire plc.

In contrast to Kerry Group, the three 'me too' mixed co-operative – plc companies meagre share appreciation (IR80p in 1989 to IR£1 in 1999) shows that wealth has been destroyed taking the cost of capital into account.

Listing on the stock exchange and adopting a diversification strategy through acquisitions is not a recipe for guaranteed wealth creation.

The Irish examples demonstrate that meeting investor shareholders expectations has priority over the milk price paid to co-operative members. Farmers, agribusiness analysts and even co-operative/plc executives agree that “co-operatives and plc’s do not make happy marriages”. Kerry Group management, the architects of the structure, has concluded that dairy co-operatives and plc’s are not a compatible mix if more than 20% of the business involves members’ milk. They believe investor capital is not appropriate for New Zealand co-operatives as our business is dominated by members’ milk and the pressure on milk price would be extreme. New Zealand’s opportunity for organic growth is viewed with envy. This growth option was closed to European farmers with the introduction of milk quotas in 1984.

3.6.8 Zwanenberg’s Theoretical Model

Dr Adrie Zwanenberg proposed a model for dairy co-operatives that meets the needs of milk supplying members while simultaneously meeting the needs of an international dairy company operating in the globalising dairy market (Ph.D. Thesis 1997). The crux of this model is the distinction between the collection, processing and marketing of members milk which is ring-fenced within the co-operative, and of the other dairy and non-dairy activities which are within a dairy plc. A linking co-operative holding company enables the co-operative to collect voluntary vested-interest capital from co-operative members to be added to its controlling investment holding company. This ensures that the co-operative retains the majority shareholding and influence in the dairy plc.

Zwanenberg’s structure ensures that the co-operative characteristics and benefits to milk producing members are not compromised, while providing the dairy plc with the critical mass to indirectly improve the value of members’ milk. Retaining the co-operative as a distinct, separate entity ensures that ‘milk price’ is not used as the buffer to maintain the plc’s profit. Linking the co-operative to the plc via the holding company will indirectly add value to members’ milk and generate capital (dividend) for the co-operative.

New Zealand Faces Unique Challenges

The New Zealand dairy industry faces unique challenges. New Zealand has a near total reliance on export markets and access is severely restricted. Milk from New Zealand has other export restrictions: milk is 86% water and New Zealand is geographically isolated from our international markets.

These factors combined with the cost of air freight prevent New Zealand from exporting liquid milk and short shelf life chilled products. To access these market opportunities, New Zealand exports powders for recombination in target markets.

Based on his ten years experience as CEO of the New Zealand Dairy Board, Warren Larsen's general rule of thumb is "if imports from New Zealand reach 15% of the domestic production, they trigger political defense mechanisms of tariffs and restricted market access. To overcome this problem and create the necessary market dominance for success, Fonterra must use non-member milk and become a corporate citizen of countries it wishes to have a presence in".

Zwanenberg's Model Not Appropriate for Fonterra Co-operative Group

Larsen believes that Zwanenberg's model is not appropriate for Fonterra. Given the unique characteristics of the New Zealand dairy industry, Larsen believes it is imperative that Fonterra's co-operative members continue to fund strategic use of joint ventures internationally to acquire the necessary critical mass to add value to members' milk. To differentiate between 'members milk activities' as distinct from 'other activities' as proposed by Zwanenberg, defeats the purpose of Fonterra Co-operative Group's joint ventures and the co-operative purpose of maximising the value of and therefore payout for members' milk. The value of Fonterra Co-operative members' milk is inextricably linked to the value of non-member milk.

Depending on definition, between 50% and 75% of Fonterra's dairy product is sold as largely undifferentiated commodities. If Fonterra Co-operative Group were to adopt Zwanenberg's model, the vast majority of co-operative members' milk would be sold to the dairy plc at commodity prices. While Fonterra co-operative members would receive a dividend proportional to the capital provided by the co-operative through the holding company, they would have lost the opportunity to add value to their milk. Fonterra co-operative members would be largely confined to commodity trading. The value added to members' milk would be distributed as a dividend or appreciating share value to all investing shareholders.

3.6.9 Joint Ventures

The New Zealand dairy industry has and plans to continue using joint ventures with foreign dairy companies in the target markets to mitigate market access restrictions and our geographical limitations. In addition to a source of 'committed' or 'smart' capital and local milk supplies, joint ventures have provided 'corporate citizen' status and acceptability,

knowledge and understanding of local market, and increased market access for New Zealand sourced dairy product.

While Fonterra Co-operative Group is 100% farmer owned, our 60 subsidiary joint ventures are not. A dairy industry accountant estimates that approximately 15% of the capital associated with Fonterra's total business activities in 2002 (including joint ventures) is provided by joint venture partners. As previously discussed, Fonterra is funded by 'outside' capital in order to attain the necessary critical mass to operate in the globalising dairy market. This 'outside' capital is invested in potentially synergistic joint venture dairy business. As with Zwanenberg's model, this outside capital does not compromise the co-operative nature and characteristics of Fonterra Co-operative Group.

"With strategic use of joint ventures, confining investments to adding value to members' milk, and a maximum milk supply growth rate of between four and six percent per annum, Fonterra shareholders can and should fund future capital requirements." (Warren Larsen.)

New Zealand dairy farmers' future prosperity relies on meeting the co-operative needs of supplying shareholders while simultaneously meeting the market-related needs of our internationally focused dairy business. New Zealand's dairy industry has unique challenges based on a high proportion of exports, restricted market access and isolation from export markets. Consequently adding value to Fonterra members' milk can only be achieved with the use of non-New Zealand milk. Fonterra Co-operative Group's present structure ensures that the co-operative benefits to milk producing members are not compromised, while enabling sufficient critical mass and market access to directly and indirectly (using non-member milk to increase market access opportunities and market dominance in targeted markets) improve the value of members' milk.

4 Zwanenberg's Model for Modern Dairy Co-operatives

4.1 Introduction

In 1999 the New Zealand dairy industry reached a critical, very significant stage of its evolution. The industry had rationalised from 20 dairy co-operatives in 1990 down to four dairy co-operatives, with Dairy Group (58%) and Kiwi Dairy Co-operative (40%) dominating the industry.

Deregulation and the removal of the New Zealand Dairy Board's single seller status was on government agenda and looked likely. Discussion and debate regarding possible re-structuring options was everywhere. 'MergeCo', the name given to the proposal to merge Dairy Group and Kiwi dairy co-operatives with subsequent amalgamation of the New Zealand Dairy Board, was the option preferred by the majority of dairy farmers. MergeCo would retain critical mass in the international market and avoid value destruction of the industry that had been collectively built.

As our industry reviewed and debated its structural, strategic and capital options, I was fortunate to spend time with Dr Adrie Zwanenberg. Dr Zwanenberg, now a Senior Industry Analyst for Rabobank International, completed his Doctoral Thesis in 1997 titled 'European Dairy Co-operatives Developing New Strategies'.

Dr Zwanenberg's thesis provided a theoretical framework for my Nuffield study and together they have been very beneficial in consolidating my understanding of the unique, critical characteristics of dairy co-operatives, the challenges modern co-operatives face in the rapidly changing global dairy market and the implications of sourcing 'outside' capital for co-operative members.

Given the eventual formation of MergeCo in December 2000, now renamed Fonterra Co-operative Group Limited, and the current (2002) strategic review being undertaken by Fonterra, many of Zwanenberg's comments and conclusions are pertinent and relevant today.

Zwanenberg's thesis addressed the issue co-operatives worldwide are grappling with – how can co-operatives retain their unique member-oriented characteristics, while simultaneously acquiring the critical mass in terms of milk and capital to compete in the globalising dairy market? He proposed a

model that would meet the needs of both co-operative members and a global dairy company.

4.2 Rapidly Changing Dairy Market

The dairy market, namely consumer demand, competitive behaviour, market access and protectionism policies have changed considerably in the last ten years. The rate of change is accelerating.

Consolidation of companies in the food value chain means the dairy market is increasingly dominated by a smaller number of very powerful international buyers. Consumers in industrialised countries demand more variety and better quality. Demand for dairy products in emerging economies is increasing rapidly. European and American companies, while having almost exclusive, 'protected' access to their own domestic and trading block markets, recognise the growth opportunities associated with emerging markets. While overall world demand for dairy foods is growing at 2% per annum, the emerging dairy markets of India, Pakistan, South America and China have the highest levels of growth at 4%-6% per annum (PA Consulting, "The Australasian Dairy Industry", March 2000). These emerging markets offer significant growth opportunities for dairy companies and are highly sought after.

Trade liberalisation is occurring, albeit slowly and dairy companies are adopting strategies to position themselves accordingly. The Uruguay GATT Agreement for period 1993-2000 negotiated a reduction in domestic support (20%), increased market access (5%) and reduced export subsidies (21% by volume and 36% by value). The European Union, Japan and North American trading blocks are reducing their dairy sector protectionism policies. The EU has reduced the volume and payments for subsidised exports. However, market access to the valuable dairy markets of EU, North America and Japan is still very limited and highly tariffed. The 1999 collapse of WTO talks in Seattle has slowed progress on further trade liberalisation

Developments in governmental policies, in consumption patterns, in the food industries and retailing have all caused an intensification of competition between dairy company's worldwide.

The competitive battle is fought with cost leadership, market leadership, economies of scale and production efficiencies, product and technological innovation, widening product portfolios, branding and marketing, etc. Strategic alliances, joint ventures and acquisitions have become the "in" business strategies that companies world-wide utilise to gain brands,

customer base, market share, countervailing power, efficiencies, low cost raw materials, technology or expertise. Partnerships and acquisitions are a means to rapidly gain competitive advantage in the marketplace.

The international dairy market is characterised by intense competition, globalisation and rapid rationalisation. Critical mass in terms of product and capital is required to achieve market share and successfully compete in the international dairy market.

The vast majority of dairy foods are produced and consumed domestically. Only 5% of global dairy production is traded internationally. In contrast, only 4% of New Zealand's dairy produce is consumed domestically. A full 96% of New Zealand's milk is exported into the international market. Consequently, New Zealand is a significant player with a 31% market share of the internationally traded dairy market – a market that is constrained in growth by “glacial” trade liberalisation, and one that is often used as the market of last resort by protected dairy sectors.

While the international dairy market is a mire of protectionism and politics, growth opportunities are available in the 95% of the dairy market that is not traded internationally. However, gaining access to and competing in these domestic markets requires capital investment in international subsidiaries and the purchase of local milk supplies. Competing in domestic markets also requires significant capital for research and development and “marketing”. PA Consultants estimate that *“the largest global dairy companies are spending in the region of US\$250m to US\$650m on branding and US\$400m to US\$800m on research and development each year”* (“The Australasian Dairy Industry”, March 2000.)

4.3 The Rationale for Dairy Co-operatives Originates at the Farm

Co-operatives have evolved in response to the collective needs of farmer producers. The co-operative is often referred to as “an extension of the dairy farm” indicating the strong link between the farm and the processing-marketing co-operative (Zwanenberg, A. “European Dairy Co-operatives Developing New Strategies”, Doctoral Thesis, 1997.)

Zwanenberg explains that the rationale for dairy farmer investment in dairy co-operatives originates within the farm gate. *“The urge to secure the processing of the milk is not driven by emotional forces but from technical and economical factors determined at farm level.”* (Zwanenberg, 1997.)

With respect to the production and sale of milk the following apply:

Asset specificity: Milk production demands a high level of production specific investment within the farm gate. Cowsheds, milking plant and dairy cows are all specific milk production investments. Many of the skills and knowledge acquired by dairy farmers is also specifically related to milk production.

Uncertainty: Dairy farmers produce and sell milk in a very uncertain environment. ‘Uncertainties’ include the weather, disease, national and international politics, and the international dairy market. Given New Zealand dairy farmers’ reliance on ‘milk from grass’ – the supply of which is definitely uncertain, and the very high proportion (96%) of our production traded internationally, our ‘uncertainty’ is the most certain phenomena of our industry.

Frequency: Milk must be harvested regularly and is highly perishable. Dairy farmers need a very regular and guaranteed outlet for all of their milk, all of the time.

Asset specificity, uncertainty and frequency are the fundamental motives for dairy farmers to invest in and commit to a co-operative dairy company. Farmers are forced to look for, or create securities at the next stage of the production chain to secure their individual farm businesses.

Collectively farmers increase the value of milk by vertically integrating the value adding processing and marketing of milk in the co-operative. Collectively sharing the risks and rewards of owning the processing and marketing of our milk reduces our exposure to risk at the farm level, in processing and in marketing end products.

Business continuity and maximising return on investment are the drivers of all successful businesses, including dairy farming. At the dairy farm level these equate to a guaranteed outlet for milk, at the best sustainable price.

“Given that the rationale for dairy co-operatives lies at farm level, the dairy co-operative mission must be entirely orientated towards the problems of the dairy farm business.” (Zwanenberg, 1997.) This does put certain limitations or requirements on the co-operative company.

4.4 Unique Characteristics of the Co-operative Company

It is a common misconception that co-operatives are not commercial or performance driven in comparison to 'conventional' (publicly listed or private company) businesses. A co-operative is equally commercially focused on generating an operating surplus. However a co-operative does have distinguishing features with respect to ownership and control, milk intake strategy and the determination and destination of the operating surplus. These are the characteristics that distinguish co-operatives from conventional companies.

4.4.1 Ownership and Control

Dairy farmers invest in and own the processing and marketing co-operative to secure their on-farm investment. Milk and capital are jointly supplied. Compulsory capital contribution and voting power are proportional to the level of milk supply. Milk is the mainstay of the dairy co-operative whereas providing capital is only an aid to allow the co-operative 'company' to achieve its purpose. Consequently capital supply, distribution of operating surplus and voting are all proportional to members' milk supply.

Representation and governance of the co-operative are designed to ensure that the best interests of the farmer members' are served, and to give members control and an involvement in decision-making.

Member ownership and control are fundamental in ensuring that the purpose and priorities of the co-operative are not compromised.

By comparison, individuals invest in conventional dairy companies to maximise their return on investment in that entity. Representation and governance of a plc are designed to serve the interests of investors; namely return on capital invested. Voting power is dependent on the level of capital invested. Conventional companies are not concerned in solving the suppliers problems beyond being able to secure their raw material – milk. Plc management's first responsibility is to capital investing shareholders, which means maximising profit and share value.

Member commitment to and participation in the business also distinguishes the co-operative from the conventional company. Given the combined supply of milk and capital and the collective vote on confidence issues, the co-operative cannot achieve its business objectives without the support of member suppliers. *"The committed response of members is the most valuable achievement of the co-operative. If the members feel that their co-operative is valuable to them then they are prepared to finance it, they want*

to do business with it, they also take part in its management and they are prepared to accept the rules of the co-operative and to subordinate their own interest to that of the collective interests. Active participation by members is also important as a means of ensuring that the co-operative continues to focus on meeting the members needs. It is essential that true commitment is not the result of propaganda and proselytising, but must arise from the fact that the co-operative is the best alternative for the members. The co-operative must be aware of and capable of solving the current problems of its members.” (Nilsson 1995, Interview in Campina Melkunie’s C-operative Members Magazine.)

“Members have to be kept very well informed to obtain their support for the strategy. If members are not well informed, they necessarily focus exclusively on the highest possible milk price. Eventually the co-operative is forced to use too great a part of the operating surplus in payout, leaving insufficient funds for longer term investment strategies.” (Zwanenberg, 1997.) Zwanenberg’s thesis highlights the cost of failing to gain the support and commitment of members to the co-operatives strategy. Costs are not only in an exclusive focus on payout, but ultimately in the loss of members and the associated milk and capital. A reduction in the co-operatives critical mass impacts negatively on its efficiency, ability to execute the strategy and competitive position in the globalised dairy market.

4.4.2 Milk Intake Strategy

The fundamental reason for belonging to a dairy co-operative is the right for members’ to deliver all of their milk to the co-operative. It is the co-operatives’ responsibility to process all of the members milk into the most profitable products, while simultaneously ensuring the product mix is broad enough to spread the risks of market uncertainty.

Processing all milk results in a less profitable product mix, which inevitably leads to a lower payout. This is the price members must pay in return for the guaranteed outlet for all milk members choose to supply. Obviously, if the price for milk delivery right is too high, present and prospective co-operative members will look for supply alternatives. This situation is exacerbated in New Zealand where variation in our milk supply between seasons is as much as 20%. For members or management to view the obligation to process all the members milk as an obstacle to performance, is “the wrong way of looking at it” according to Zwanenberg.

Dairy co-operatives, by virtue of their purpose must first take all of their members’ milk and then determine the most profitable product mix. Co-operatives, by their very purpose are “production driven”.

The dairy co-operative has a constant obligation to process members' milk only. However, the co-operative can demand certain conditions of members, and can pay different prices depending on quantity, quality, seasonality or special properties of the milk etc.

Conventional dairy companies identify which products will generate the best profit, then calculate how much milk they will require to achieve this. Sourcing the required amount of milk comes last. Conventional companies are "market driven". For example, in 1998 Nestle and Wessan Plc's in the Netherlands had more milk than needed to implement their strategy; reducing the milk supply increased profit. They reduced the milk prices to below that of other processors as a disincentive for supply.

A co-operative may choose to be more market driven for the purpose of shifting the growth focus from increasing milk volume to increasing milk price. This results in a 'closed' approach to new milk supply. For the benefit of a higher milk price, farmer suppliers forgo the right to grow their own farm business by increasing milk output and give the marketer the right to determine how much milk is required based on market demand.

A market orientated co-operative does impact on one of the fundamental characteristics of a co-operative – the members right of a guaranteed outlet for all the milk they choose to supply.

In the case of co-operative over-capacity, contracting for the supply of milk from non-members is an option. Respecting the investment members have and will continue to make over time, must be recognised in differentiated payouts to member and non-member (contract) suppliers. If being a non-member is very profitable in terms of milk price there will be great tension between members and non-members. Zwanenberg (1997) recommends limiting the percentage of non-members and offering them a lower price to ensure the stability of the co-operative.

4.4.3 Determination and Destination of the Company Surplus

Within the obligation to take all members' milk, the co-operatives second priority is to maximise the payout to members. A co-operative's operating 'surplus' (income – costs) is paid to supplying members in proportion to their patronage or milk supply. Distributing the 'surplus' on a patronage basis is fundamental to a co-operative. A dairy co-operative is a milk company not an investment company. Milk is not accounted for as a 'costed raw material'. The payout for milk is dependent on co-operative performance. To ensure the continuity of the dairy co-operative, a portion of the surplus is retained in reserves. This enables the co-operative to maximise the payout both now and in the future.

Dairy farmer capital is invested in processing and marketing, “*not to achieve the highest possible return on that capital but to enable the dairy co-operative to sell farmer members milk for the best possible payout, now and in the future. Focusing on maximising the return on capital invested by members in the processing and marketing co-operative in isolation is meaningless. Dairy co-operatives must focus on the highest possible return on member dairy farmers’ capital; that is of the combined dairy farm and the processing and the marketing. The return on members’ capital is included in the payout proportional to milk supply.*” (Zwanenberg 1997.)

Attempts to differentiate the returns for milk or capital are always arbitrary in a co-operative. There is no supply-demand market for raw milk so a ‘real market value’ can not be established. If an assumption is made for the cost of capital, the ‘operating surplus’ is paid as milk price, or if milk is assigned an arbitrary value or cost, the ‘operating surplus’ is paid as the return on capital.

If a co-operative does differentiate between “milk price” and return on capital, assuming a market based cost of capital and paying the ‘operating surplus’ as milk price is more likely to retain the co-operative characteristic. Assigning an arbitrary milk price is a risk to the co-operative as it starts to behave like an “investment” organisation where the focus and emphasis is on return on capital.

Fonterra’s ‘actual milk price’ is an arbitrary value assigned to members’ commodity milk returns. The actual milk price assumes a transfer price between the commodity business (NZMP) and value adding business (NEW ZEALAND MILK). The artificially determined ‘operating surplus’ is paid as a dividend, proportional to milk supply. While this arbitrary differentiation supports a performance driven culture and some degree of transparency, the reality is that co-operative members must judge their co-operative in terms of the total payout they receive per kilogram of milksolids supplied.

For conventional companies, milk is an input to be sourced at the lowest cost possible. A high milk price results in higher costs and lower profits. For the investor, this means lower dividends and share values. Interestingly, a strong co-operative operating in the same location as a conventional company mitigates this milk pricing strategy as conventional companies are forced to pay similar milk prices in order to secure milk supply. Farmers supplying milk to conventional companies in this situation “free ride” on their co-operative neighbours. Co-operatives then, are price setters for conventional companies. However, conventional companies use price to attract or discourage milk supply. Predatory pricing is used strategically to draw milk supply and capital away from the co-operative. It is only when the

co-operative is sufficiently weakened and the co-operative's milk price falls that conventional companies can also drop the milk price they pay.

4.5 Is the Co-operative the Best Alternative for Dairy Farmers?

The co-operative has unique distinguishing characteristics with respect to ownership and control, milk intake strategy and the determination and distribution of company operating surplus. These ensure that the company meets the dairy farmer members' priority needs of a guaranteed outlet for all of their milk and the best milk price now and in the future. A co-operative is the best structure for dairy farmers.

The intense competition in the international dairy market is increasing dairy company's requirements for capital, whether they are co-operative, private or plc. From the co-operative members' perspective, it is also essential that the processing and marketing dairy company is able to continue to compete successfully in the marketplace. Failure to do so will result in the demise of the co-operative company.

As co-operatives grapple with financing their strategies, a topical option for dairy co-operatives is to float part or all of the co-operative to access capital from 'outside' investors, i.e. become part or whole publicly listed company. Zwanenberg's thesis addressed this issue from the dairy farmer members' perspective.

Dr Zwanenberg believes it is not advisable to divide up the processing and marketing of members' milk into 'commodity' products in the co-operative and 'value-added' products in the plc. This has been a common approach taken in recent restructuring of European co-operatives and is also a model that has some support in New Zealand. The risk's are:

4. The value-adding plc will take only the milk it needs to maximise profit, thereby restricting the proportion of members' milk going into value-added products. The co-operative obligation to process all members' milk into the most profitable product mix does not apply in this structure.
5. The potential to earn a better milk price from value-added products will be out of co-operative members' control.
6. The co-operative could be left with low value, and possibly unprofitable, commodity products. Commodity prices are declining at 2% per annum.

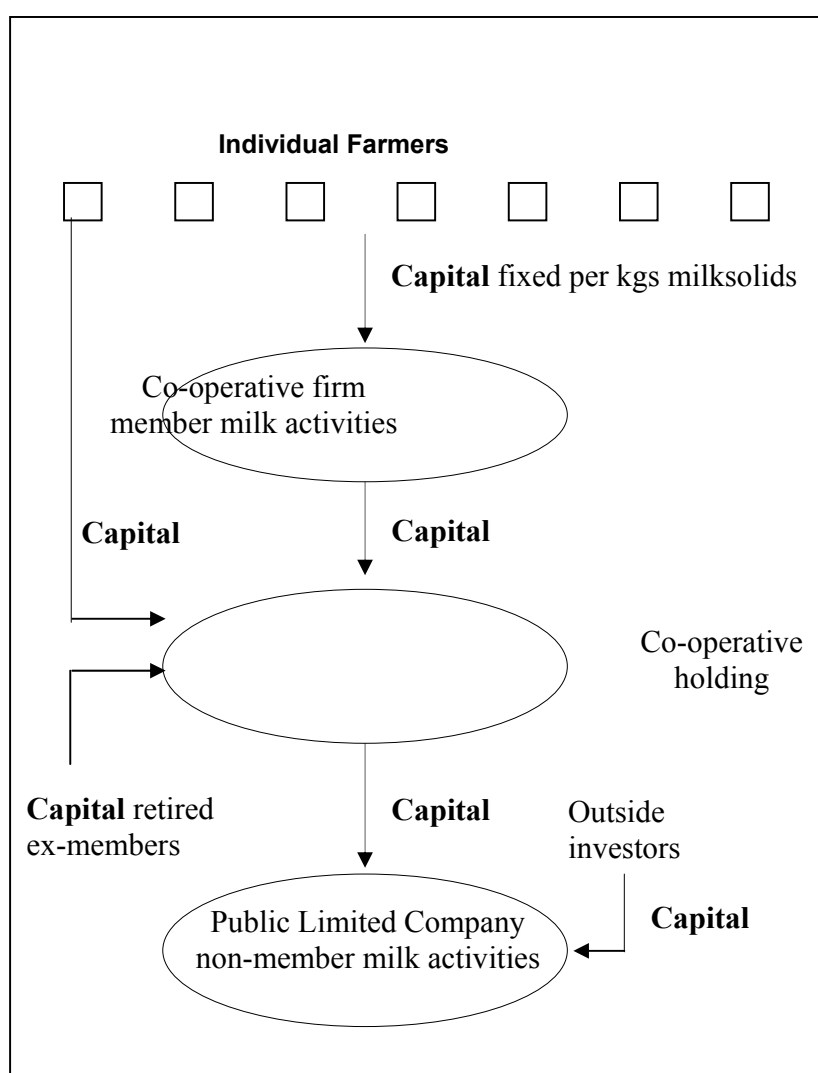
In defining the rationale for dairy co-operatives and identifying and comparing their unique characteristics to conventional companies, Zwanenberg concluded *“a dairy co-operative is the best alternative for farmers. Dairy farmers must supply 100% of the capital to retain the ownership and control of the processing and marketing of their own milk”*.

“If the members are not in a position or not willing to provide the necessary risk-bearing capital for the processing and marketing of their own milk, then the dairy co-operative concerned does not have the right to exist” according to Dr Zwanenberg.

4.6 Is it Possible to have ‘the Best of Both Worlds’?

The case studies presented in this report demonstrate that it is essential for dairy farmer security and viability that the co-operative is totally owned and controlled by milk supplying shareholders in proportion to the amount of milk they supply. This ensures that the co-operative is dedicated to serving the interests of dairy farmer members. The two priority functions of a dairy co-operative are first, a guaranteed market for all the milk members choose to supply and second the best possible sustainable payout.

For the co-operative company to be able to compete in the globalising dairy market, it requires critical mass. A global strategy invariably involves the procurement, processing and marketing of non-member milk. Establishing or acquiring offshore companies to secure competitive advantage such as market access, brands, cheap raw materials or to complement shortfalls in supply require large sums of capital, often at short notice. Questions arise as to whether members’ compulsory capital contribution to the co-operative should be used to fund such activities that indirectly add value to members’ milk. Dr Zwanenberg concludes that sourcing ‘outside’ investor capital in a specifically formed structure to fund these activities will not undermine the unique characteristics of a co-operative.

Figure 1: Zwanenberg's Model for Modern Co-operatives

The crux of Zwanenberg's structure is the distinction between the processing and marketing of members' milk, which is ring fenced within the co-operative, and of all of the other dairy and non-dairy activities, which are within the dairy plc.

The ownership, purpose and activities of the three entities within Zwanenberg's model for modern co-operatives are as follows:

Dairy Co-operative:

- 100% dairy farmer owned and controlled.
- Compulsory capital investment and voting power allocated in direct proportion to members' milk supply.
- Purpose is to process all of the milk supplied by members into the most profitable product mix possible.
- Responsible for the collection, processing and marketing of members' milk.
- Co-operative operating surplus paid to members in proportion to milk supplied (excluding retained earnings).

Co-operative Holding:

- Collects voluntary capital from co-operative stakeholders for investment in dairy plc, added to the co-operatives' contribution of controlling capital.
- Retaining the co-operative shareholding in a block rather than placing the shares with the individual members enables farmers to collectively wield greater control and influence in the dairy plc.
- 'Co-operative stake-holder' investors could include co-operative members and employees, retired co-operative members and sharemilkers.
- Purpose is to provide capital to invest in the dairy plc and therefore the central aim is to maximise return on that investment. The co-operative's share of the dividend paid via the holding company can be used as capital in the co-operative.
- Co-operative members who choose to invest more capital in the dairy industry than is compulsory based on their milk supply, can do so in the co-operative holding without compromising the purpose and priorities of the co-operative. This avoids the impossible task of differentiating and determining milk price from return on capital invested in the co-operative. Creating 'investing' and 'supplying' shareholders within the co-operative is not advised as it generates a conflict of interest between the different types of members.

Dairy Public Listed Company:

- Co-operative holding retains the majority shareholding and consequently has the greatest influence and voting power in electing directors and hence management for the dairy plc.
- ‘Outside’ investors become shareholders in the dairy plc, with voting power proportional to their capital investment.
- Purpose is to maximise return on capital invested in the dairy plc.
- Activities can include anything except the processing and marketing of co-operative members’ milk. Provided the co-operative holding retains a majority shareholding in the dairy plc, it has the potential to indirectly add value to co-operative members’ milk.
- The dairy plc would be both a ‘customer’ and ‘competitor’ for the co-operative. Through the vested interest shareholding in the dairy plc, the co-operative would be the ‘preferred supplier’. The plc’s objective is to maximise profit; therefore the plc would buy product at the world market price. The advantage for the co-op is that it would have a market for undifferentiated commodity products, and would also receive its share of the dividend this commodity product contributed to the plc’s profit.

Zwanenberg’s structure ensures that the co-operative benefits to milk producing members are not compromised, while providing the dairy plc with sufficient critical mass to indirectly improve the value of members’ milk. Retaining the co-operative as a distinct entity ensures that ‘milk price’ is not used as the buffer to maintain the plc’s profit. Linking the co-op to the plc via the holding company will indirectly add value to co-op members’ milk and generate capital for the co-operative.

Any structure that mixes any of the co-op members milk activities with the plc activities, will inevitably result in milk price being compromised to appease investor appetite for profit and appreciating share value. 100% of the New Zealand dairy industry’s raw material is milk. In a structure where member interests are blurred with non-farmer shareholder interests, the pressure to reduce milk price would be extreme.

Dairy companies, including co-operatives are investing in ‘offshore’ subsidiaries in the growth markets of South America and Asia.

South America is an example of a rapidly growing dairy market both in terms of milk production and consumer demand. Argentina has ‘low cost’

milk supply and its location adjacent to the high growth market in Brazil and membership of the Mercosur Trade Agreement makes Argentina a target for multinational acquisitions. American, European and Australian multinationals have acquired dairy businesses to access Argentina and surrounding markets. Competitive demand for acquisitions in Argentina has increased the cost of this strategy. This example highlights the importance of a dairy entity that has efficient decision-making and fast access to large sums of risk-bearing capital. The dairy plc has these advantages, without compromising the benefits of the co-operative.

It is interesting to note that Zwanenberg's model has not been adopted by dairy co-operatives, despite the 'New Millenium Strategy' of globalisation. Possible reasons include:

- It is impractical and expensive to duplicate two marketing businesses, one for the co-operative and one for the dairy plc, particularly in the early stages of adopting this model.
- In a globalising dairy market, the opportunity to add value to members' milk is inextricably linked with the use of non-members milk.
- The risk that there is no drive or motivation for the co-operative to add value to members' milk. It could be easier to sell undifferentiated product to the dairy plc and indirectly add value through the dividend.

4.7 Is Zwanenberg's Model Appropriate for Fonterra Co-operative Group?

4.7.1 Unique Realities of the New Zealand Dairy Industry:

As previously mentioned, New Zealand is a significant player in the international dairy market. Ninety-six percent of New Zealand milk is exported, and this is likely to increase as New Zealand's organic milk growth continues. This near total reliance on export markets is unique to New Zealand. Only five percent of the world's milk is traded internationally.

4.7.2 Restricted Market Access

Ninety-five percent of the world's milk production is produced and consumed in domestic markets.

Unfortunately, New Zealand faces limited market access to many of these markets as dairy sectors worldwide are heavily ‘protected’ by import quotas and tariffs. Tariffs on dairy products are approximately 30%, compared to 4% on manufactured goods.

In 2001, the New Zealand Dairy Board paid in excess of NZ\$600m in tariffs.

4.7.3 Geographical Restrictions

New Zealand sourced milk has other export restrictions. Milk is 86% water and New Zealand is geographically isolated from our international markets. These factors combined with the cost of air freight prevent New Zealand from exporting liquid milk and short shelf life chilled products. To access these market opportunities New Zealand exports product in powder form for recombination in target markets.

4.7.4 Rationale for New Zealand’s Use of Joint Ventures

The New Zealand dairy industry has used joint ventures with foreign dairy companies in the target markets to mitigate these restrictions. In addition to a source of ‘committed’ capital and local milk supplies, joint ventures have provided:

- ‘Corporate citizen’ status and acceptability
- Knowledge and understanding of local business norms and cultural issues
- Increased market access for New Zealand sourced dairy products.

Warren Larsen was CEO of the New Zealand Dairy Board for ten years up to 2001. He explained his experience of marketing New Zealand dairy products internationally through joint ventures: *“As a general rule of thumb, if imports from New Zealand reach levels of greater than 15% of the domestic milk production, they trigger political defence mechanisms of tariffs and restricted market access. To overcome this problem and create the necessary market dominance for success, Fonterra must use non-member milk and become a corporate citizen of countries it wishes to have a presence in.”*

Larsen believes that Zwanenberg’s model is not appropriate for Fonterra. Given the unique characteristics of the New Zealand dairy industry, Larsen believes it is imperative that Fonterra’s co-operative members continue to fund strategic use of joint ventures internationally to acquire the necessary

critical mass to add value to members' milk. Joint ventures in foreign markets have been used to re-process or finish processing New Zealand milk into higher value saleable products, as well as a means of market access and acquiring local expertise. To differentiate between 'members milk activities' as distinct from 'other activities' defeats the purpose of the joint ventures. The value of Fonterra Co-operative members' milk is inextricably linked to the value of non-member milk.

Fonterra Co-operative Group Limited is divided into two operating divisions; NZMP is responsible for the processing and marketing of New Zealand produced commodities and ingredients, and NEW ZEALAND MILK is responsible for the fast moving consumer goods activities. The joint ventures are subsidiaries of NEW ZEALAND MILK. This is the same operating structure used by the New Zealand Dairy Board (NZDB), the marketing arm of the co-operative industry prior to the formation of Fonterra.

The contribution of Fonterra's joint venture activities in adding value to New Zealand members' milk is significant. In the year ending 31 May 2001, 385,000 tonnes of product (24%) was distributed through NEW ZEALAND MILK, (fast moving consumer goods operating division of the New Zealand Dairy Board), and contributed half of the EBITA (earnings before interest, tax and amortisation). This division 'buys' commodities from NZMP at a transfer price, and adds value to them in the foreign market through reprocessing and packaging. The other 76% of largely undifferentiated commodity product sold through NZMP contributed the other half of the EBITA.

Owning and controlling both of these operating divisions also underpins the cycles in commodity prices and prevents extreme volatility in co-operative members' incomes. When commodity prices are low, the operating margins of NEW ZEALAND MILK are higher than when commodity price cycles are high. This strategy requires a long-term focus.

Depending on definition, approximately 75% of Fonterra's dairy product is sold as largely undifferentiated commodities. If Fonterra were to adopt Zwanenberg's model, the vast majority of co-operative members' milk would be sold via the dairy plc at commodity prices. While Fonterra co-operative members would receive a dividend proportional to the capital provided by the co-operative through the holding company, they would have lost the opportunity to add value to their milk. Fonterra co-operative members would be confined to commodity trading. The value added to members' milk would be distributed as a dividend or appreciating share value to investing shareholders.

While Fonterra Co-operative is 100% farmer owned, our 60 subsidiary joint ventures are not. A dairy industry accountant estimates that approximately 15% of the capital associated with Fonterra's total business activities (including joint ventures) in 2002 was provided by joint venture partners. As previously discussed, Fonterra is funded by 'outside' capital in order to attain the necessary critical mass to operate in the globalising dairy market. This 'outside' capital is 'invested' in potential synergies in the joint venture dairy business.

“With strategic use of joint ventures, confining investments to adding value to members’ milk [directly and indirectly], and a maximum milk supply growth rate of between four and six percent per annum, Fonterra shareholders can and should fund future capital requirements.” (Warren Larsen)

New Zealand dairy farmers’ future prosperity relies on meeting the co-operative needs of supplying shareholders while simultaneously meeting the market-related needs of our internationally focused dairy business. New Zealand’s dairy industry has unique restrictions. Fonterra’s present structure ensures that the co-operative benefits to milk producing members are not compromised, while enabling sufficient critical mass to directly and indirectly improve the value of members’ milk.

5 The Netherlands

5.1 Netherlands Dairy Industry

5.1.1 Farms

Despite the Netherlands's relatively small land mass, it is the fourth largest dairy producing country within the EU. Average herd size is 45 cows, with an average yield per cow of 7,000 litres. Dutch cows have the highest composition of fat (4.4%) and protein (3.5%) in Europe. There are 38,000 dairy farmers in the Netherlands however; this is nearly half the number of farmers in 1983 before EU quotas were introduced. The introduction of milk quotas led to significant on-farm rationalisation and reduced Netherlands's milk production by 20%.

5.1.2 Dairy Products

Cheese is the most important milk product by volume in the Netherlands. 60% of the cheese produced is the Gouda variety. In 1998 the Dutch recognised their reliance on cheese and made the strategic decision to reduce cheese production and increase butter and SMP. Reducing cheese production was intended to lift EU cheese prices, but the economic collapse of Third Country markets (export markets outside of the EU) interfered with this strategy as cheese was deflected into the EU. Liquid milk is the second biggest use for Dutch milk. Other significant products are condensed milk, WMP and lactose.

5.1.3 Destination and Milk Price

Approximately one-third of revenue is earned in the domestic market, 40% is derived from exports to the rest of the EU (Germany is the most significant destination, followed by Belgium and the UK), and 25% is derived from exports to Third Countries. In contrast with the UK's 75% self-sufficiency ratio, Netherlands has a self-sufficiency ratio of 175%, and consequently are second only to the Irish in exporting approximately 65% of their dairy production. An historical reliance on exports to Third Countries resulted in New Zealand-style processing plants i.e., large scale, low cost commodity plants. While the recent focus has been to diversify Dutch milk into products for the lucrative intra-EU trade, exports to Third Countries means that the milk price in Netherlands is not as high as some other European countries. In 1998 farmers' received 72.45 guilders (1 Dutch guilder = NZ\$1.00) per 100 kilogram of milk.

5.1.4 Meeting 'the Publics' Expectations

A major issue facing Dutch dairy farmers is the cost of complying with public concern for the environment, closely followed by consumer demands for animal welfare standards and food safety. The Dutch farmers are quite prepared to meet these public demands, provided they are paid for doing so. This is the crux of the issue: in complying, the farmers' costs of production are being forced up but their incomes are not increasing.

Legislation is increasingly used to enforce farming practices to a high level of detail and compliance is closely monitored. Legislation now dictates farming practices such as effluent disposal methods, timing and rates; stocking density; fertiliser rates, animal feed ingredients etc. One example is the controversial issue of 'slurry' (effluent). Legislation defines the phosphate and nitrogen quotas for livestock farming, based on regulated stocking densities. Farmers must record stock numbers, feed purchases, feed analysis, feeding levels, and production, weekly. As slurry is transported to paddocks for spreading, it is weighed and composite samples are taken for analysis. Maximum application rates for phosphate and nitrogen are defined, and proof of the application rate is required. Government officials audit farmers' Nutrient Registration Records. Expensive penalties are imposed on farmers who exceed their nutrient quotas. In 1998 the penalty was 10 guilders (NZ\$10) per extra kilogram of phosphate, in 2000 it will be 20 guilders. The cumulative impact of the regulations is illustrated by the example of a pig farmer who transported slurry 200 km for spreading at a cost of 30 guilders per cubic metre; 20 guilders for transport and 10 guilders to the recipient farmer.

5.1.5 National Milk Certification

The Netherlands dairy industry is the first country in Europe to introduce a "national milk certificate". The certificate covers animal welfare practices, environmental impact standards, hygiene and milk quality standards, a disclosure regarding the use of feed additives, antibiotics and illegal substances. Dairy farmers who are not certified, receive a significant penalty equating to 20% discount in their milk price.

5.1.6 Trade

Trade liberalisation is considered "inevitable". The Dutch clearly recognise that the trend of reducing export refunds and export quantities will continue as GATT objectives for more liberalised agricultural trade take effect. The Dutch are actively working to position their dairy companies for further liberalisation. The product category most affected by the last GATT round

was cheese. Given their reliance on exports the Dutch believe they must address the potential impacts of further trade liberalisation

5.1.7 Maximise Intra-EU Dairy Trade Strategy

Intra-EU trade offers the best potential given the free market access to 380 million consumers, who pay the highest prices in the world for dairy produce, besides the Japanese. The EU has always been 'The Key Market' for European dairy companies and is highly sought after. Slow but steady GATT restrictions being placed on European exports make Third Country exports an even less attractive alternative. Being close to the customer geographically, is a competitive advantage for highly perishable fresh and short shelf life products. The German and UK markets are key strategic targets for export. Both have populations of approximately 60 million each, enjoy high disposable incomes and a high standard of living. Unsurprisingly, this strategy is not unique to the Dutch dairy companies. The Danes in particular, who are also significant and respected marketers have adopted the same strategy.

5.1.8 Intensifying Intra-EU Competition

The 1998 wave of economic collapse in Third Country markets, particularly Russia, Central Europe and Asia, and to a lesser extent Latin America has displaced a significant proportion of European exports. For example, the Irish Dairy Board normally exports 60% to other EU countries and 40% to Third Countries. In 1998 the mix was 70% intra-EU and 30% to Third Countries. The EU dairy market is becoming intensely competitive as European dairy companies attempt to divert milk traditionally intended for Third Country export to within Europe, and the 'maximise intra-EU dairy trade' strategy is increasingly adopted EU-wide. As one Dutch dairy executive said *"There will be even more intense competition for market share in the EU dairy market and there will be casualties"*.

Third Country markets have contributed significantly to EU Dairy Company turnover and profit. Export refunds and buying relatively cheap intervention commodities made it profitable to export EU milk (products) in the past. Like New Zealand, European dairy companies' often own processing facilities in export markets to add value to their commodities through activities such as recombining milk, secondary processing, packaging and branding. The gradual, but continuous reduction of export refunds is increasing the relative cost of EU milk as an input for secondary processing in Third Countries. EU milk is at least twice as expensive as milk accessible on the international market. Consequently, EU companies are sourcing more raw dairy material for their foreign subsidiaries from within those countries or on the international market at the lowest cost possible. Third Country

markets only offer viable potential growth for EU companies provided this milk sourcing strategy is used. The primary focus of EU dairy companies will continue to be diversifying their home-produced milk into products for, and gaining a share of the EU market.

5.1.9 Industry Structure

The Dutch dairy industry is well rationalised with the two co-operative giants, Friesland Coberco and Campina Melkunie accounting for 85% of Netherlands's total milk production. In addition to the two giants, there are 12 dairy entities in the Netherlands. Six of these are small processing co-operatives or milk groups who sell their milk to larger co-operatives. The plc's, including Nestles two plants, and private companies process 10% of Netherlands's milk.

Friesland Coberco and Campina Melkunie face the same challenges of reducing export subsidies resulting in intensifying competition, and downwards pressure on dairy product prices within Europe. Although both are co-operatives, these companies have very different ownership and governance structures, organisational culture, and are responding to environmental factors in quite different ways.

5.2 Campina Melkunie

Campina Melkunie based in the southwest of the Netherlands, is the result of successive mergers, the latest being the merger of DMV Campina and Melkunie Holland in 1989. Since then a series of acquisitions in Germany, Belgium and Poland have expanded the co-operatives milk supply and business activities beyond the Netherlands. Campina Melkunie has 8,500 member suppliers in the Netherlands and 1500 contract suppliers in other countries. Campina Melkunie is organised into five groups based on product category and an additional group focused on markets outside Netherlands, Belgium and Germany.

5.2.1 Strategy

As quoted in Campina Melkunie's 1998 Annual Report the strategy is "*To strengthen its position through further international growth while increasing the contribution to turnover by added-value products and maintaining cost leadership in basic dairy products*". More specifically the strategy is:

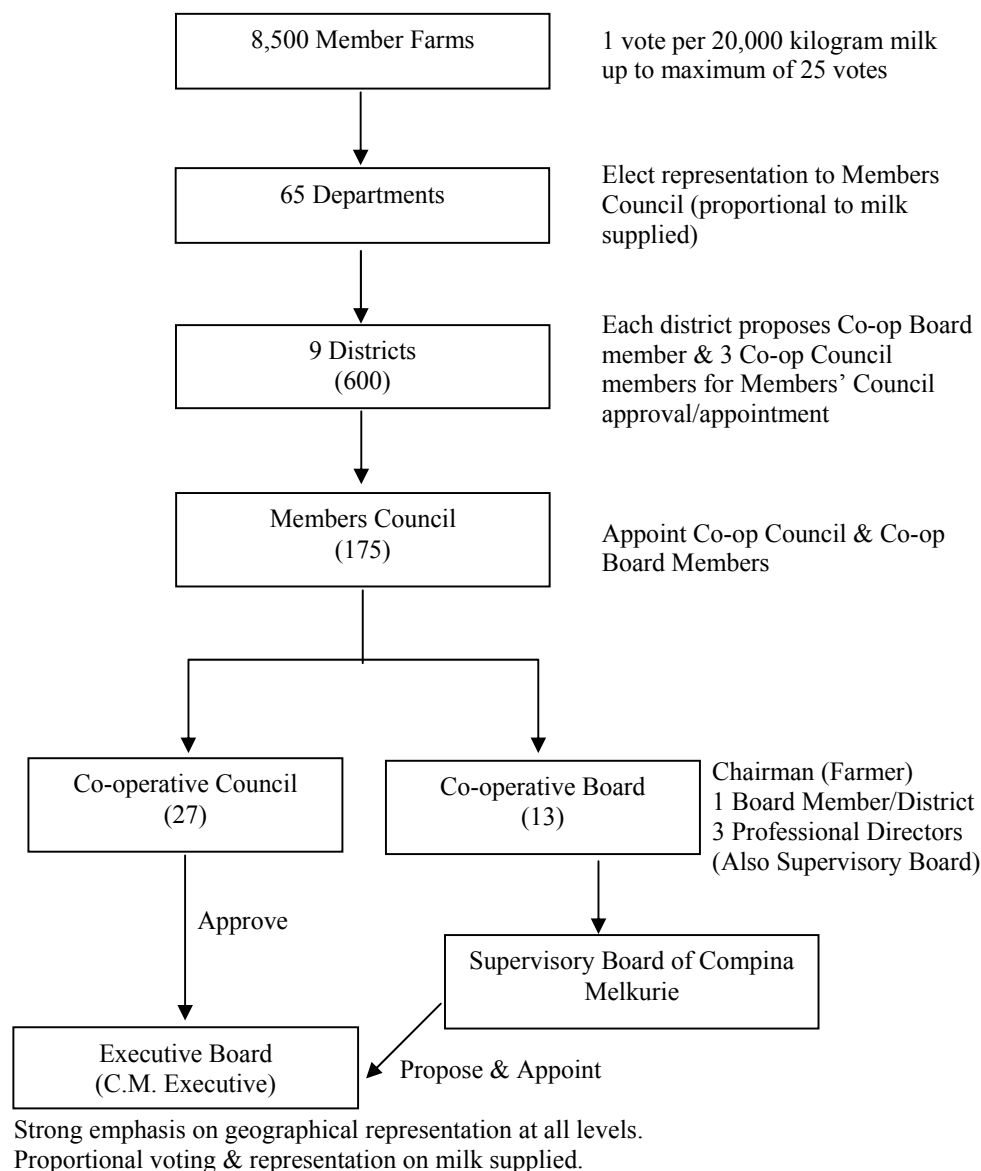
- Consolidate and expand market share of fresh, chilled consumer dairy products in Netherlands, Belgium and Germany.

- Focus international expansion in Central and Eastern Europe. Poland (will join EU), Russia and the UK are key target markets.
- Increase investment in processing facilities, product development and brands in target developing markets (Poland and Russia).
- Continue cost leadership in basic products.
- Continue developing the ingredients business, e.g. lactose, for the global market.

One executive of Campina Melkunie put it this way; *“Our hands are full defending and expanding market share in target markets in the EU and Eastern Europe. It is important that we show restraint and focus on these priorities without stretching ourselves too thin”*.

5.2.2 Structure

Campina Melkunie has a very strong co-operative culture and philosophy. While being very commercially focused and driven, Campina Melkunie’s priority is a total commitment to serving the interests of its members. It is the only co-operative described in this report whose members’ milk price is determined by company performance, rather than being “priced” as an input at a competitive market value. The philosophical difference distinguishes Campina Melkunie as truly “co-operative”.

Figure 2: Campina Melkunie Representation and Governance

5.2.3 Representation and Governance

Campina Melkunie's 8500 farmers elect their Department (ward) representatives. Voting is proportional to milk supply, with a maximum number of votes per member farm. This is the only level of representation and governance that farmer members directly vote for. In addition to consulting with and representing local issues and concerns, each Department elects their representatives to the Members Council. The 65 geographical Departments are grouped into 9 Districts. To ensure geographical

representation, each District proposes one Co-operative Board member and three Co-operative Council members to the Members Council for approval and appointment. Geographical representation is given precedence over merit-based criteria for election in the interests of superior communication, consultation, participation and sense of ownership throughout the membership. This ultimately leads to member commitment and loyalty to the co-operative.

Members Council

The Members Council has considerable influence within the co-operative. The ultimate power is the ability to dismiss the Co-operative Board with a vote of no confidence. In addition to approving or rejecting and therefore appointing Co-operative Board and Council members, the Members Council has the authority to approve or reject the company's annual accounts and the annual budget including the size and use of retained earnings. The Members Council has more access to business information, authority and influence on Campina Melkunie than the Shareholders Council has on Fonterra Co-operative Group.

Co-operative Council

The Co-operative Council provides a very close "check and balance" for the Co-operative Board. The Council receives and approves the annual budget, strategy, performance results, acquisitions and investments. Significant business proposals such as acquisitions must be approved by the Co-operative Council on behalf of all the members. The delegation of member authority to the Co-operative Council enables faster decision-making within the co-operative, while simultaneously ensuring that the co-operative's business entity reflects the aspirations of and acts in the interests of members. Although the Council do not receive Board papers, much of the information presented or provided to the Board is copied to the Council. The Council is also seen as a training ground for future Board members.

The Co-operative Board is the governing body of the commercial entity. It appoints and oversees the Executive.

5.2.4 International Co-operative Membership

The suppliers to Campina's dairy processing subsidiaries in Belgium, Germany, Poland, Russia, Austria and the UK are paid a competitive market price for their milk. However Campina was contemplating offering co-operative membership to the suppliers who owned Milchwerke Koln/Wuppertal (MKW) before it was taken over by Campina. This was

seen as a positive means of sourcing capital without compromising the co-operative philosophy, creating unity and homogeneity between all of Campina's key milk suppliers, and more importantly of securing and controlling a stable milk supply in a key target market. This did happen in late 2000. MKW suppliers have the option of becoming co-operative members. The entry fee would be paid over six years and members would receive a milk price premium.

5.2.5 Capital Structure

Campina Melkunie equity is fully provided by co-operative members by way of member certificates (interest bearing loans), member participation units (MPU) and retained earnings held in permanent, non-allocated general reserve.

In 1991 Campina Melkunie introduced member participation units, with a compulsory one-off capital contribution of Gf 10/105 kilograms milk (NZ\$1.20/kg milksolids) collected. This capital received a premium above market interest rates paid as a bonus to the milk price. Members reacted negatively to a perceived "dictatorial approach" in this issue and Campina lost 400 members. The proposal was withdrawn.

In 1998 a voluntary MPU capital contribution of Gf 10/105 kilograms milk was introduced. While MPU's are transferable, they are only of value to milk suppliers as the "yield" is paid as a bonus on top of the normal milk price. The yield is considerably higher than the market interest rate. Voluntary capital earned a bonus of 12% in 1999 included in the milk price to avoid tax. From 2001 it will be compulsory for all members to contribute Gf 10/105 kilograms milk.

In 1999 Campina introduced a move from an emphasis on collective reserves to individual capital by allocating some of the unallocated reserves in a more realistic capital value for members participation units. This was to help protect the co-operative from take over. The Board now allocates any increase in capital value to co-operative members each April with the re-valuation of the participation units. This becomes the entry and exit price for members in that financial year. Theoretically the value can increase or decrease.

Campina successfully negotiated with the Netherlands Government that the increase in value of participation units was only income "on paper" and therefore the increase in value should only be taxed if and when participation units were sold. No tax would apply when dairy farm businesses, including the participation units were transferred to the next generation. Transfer to the next generation is the common practice in the Netherlands.

However individual members have no claim on the collective equity held in reserves at this stage. Members participation units were revalued from Gf10 to Gf10.50/105 kilograms milk (NZ\$1.27/kg milksolids) in 1999 and the collective reserve amount to about Gf15/105 kilograms milk (NZ\$1.80/kg milksolids). Therefore approximately 60% of the co-operative's equity was still unallocated in 1999.

5.2.6 Co-operative Membership

New members have to pay an entry price of Gf 22.50/105 kilograms milk. This entry price includes a Gf12/105 kilograms contribution to the collectively owned reserves. The equity in 'general reserve' divided by the members total milk supply equates to approximately Gf15/105 kilograms, so existing members are subsidising new members to a limited extent. The contribution to the general reserve is not redeemable. The rationale being that this is the value built up by members collectively through retained earnings and investment over time, for the security of milk collection and payment. New members who wish to share in these benefits of the co-operative must contribute their share to the collectively owned equity.

In 1998, Nestle and Wessanen (plc's) paid their suppliers Gf 3/100 kilograms milk (NZ\$0.40c/kg milksolids) less than Campina (Gf 75.5 compared to Gf 78.5) (NZ\$9.94/kg milksolids). They had more milk than they could profitably market, so dropped the price as a disincentive for farmers to supply them. One commonly held view is that many plc's will quit Europe once the export subsidies go. The initial attraction of the Netherlands's to the plc's was milk quality and location providing access to the valuable EU market. As competition intensifies within Europe, plc's are likely to shift their focus and operations to higher growth markets. As one executive said *"Already the plc's are buying up large in South America where they can source cheap milk close to emerging markets."*

Farmers supplying the private and plc companies are prepared to pay the entry price to join Campina co-operative. The milk price in Netherlands is declining due to market displacement and increasing competition within Europe as EU support decreases. The proposed expansion of the EU borders and possible removal of quotas will exacerbate this situation. Farmers prepared to pay Campina Melkunie's entry price value the security of milk collection and payment together with the opportunities the co-operative provides for collectively adding value to their milk.

5.2.7 Co-operative Philosophy

Campina Melkunie has developed and maintained a very strong co-operative philosophy. This is reflected in the 1999 mission statement: “*Campina Melkunie is an international co-operative enterprise specialising in the development, production, sale and distribution of dairy products.*” Of note are the emphasis on the co-operative structure and the lack of restriction to “members” dairy products. As a modern co-operative, Campina Melkunie are focused on expanding their critical mass in milk products beyond that supplied by their members.

Campina Melkunie’s co-operative philosophy is commercially based:

1. Quotas limit the milk pool available for processing. The Dutch dairy companies have the most efficient processing plants in the EU, and they want to retain this cost leadership position within Europe. Losing members and milk supply will reduce plant efficiency.
2. Campina Melkunie is allocating any increases in the co-operative’s value to members by annually revaluing member participation units. This will help retain members but more importantly prevent a take-over bid.
3. Alternative purchasers of Dutch milk are available. The co-operative philosophy assists Campina Melkunie to remain and promote their company as an economic alternative for dairy farmers.
4. A commitment to open and honest communication with members, combined with members’ delegation of authority to representation and governance structures speeds up decision making and therefore execution capability of commercial business activities.

The co-operative philosophy is evident across organisational activities:

- equity capital is provided solely by co-operative members
- payout (milk price) relates to total company performance
- strategic and operational focus is on delivering benefits to farmer members
- frequent open interaction with and attitude towards shareholders is designed to ensure members are well informed and to encourage maximum participation and a sense of ownership and value

- representation and governance structures are designed to ensure geographical representation of all members
- members' capital receives a market based return to avoid compromising the co-operative's determination and distribution of operating surplus

5.2.8 Communication, Education and Training

Campina Melkunie believe that communication, education and training are key to building member trust, loyalty and commitment to the co-operative.

The negative farmer reaction to the introduction of compulsory capital contribution in 1991 and associated loss of 400 members triggered a change in communication policy.

Campina has a very simple communication policy: "Always tell the members the truth, even when it is not what the farmers want to hear". Campina go to great lengths to explain the strategy and ensure that members agree with it. The message was that "communicating with members takes a lot of time, money and effort, but it is a good investment in building trust and loyalty to the co-operative".

Some of their communication and training initiatives are:

- Two rounds of farmer meetings each year. In spring, the past years performance and the strategy going forward are explained and discussed. In autumn, the focus is educating and informing members. Attendance levels are monitored and meetings are held in each of the 65 districts to encourage attendance (60% in 1998). "We take the meetings to the farmers to get better attendance".
- Each of the nine district representatives (600 members) attends two meetings annually. One meeting is held for that district to elect their board member and to discuss supplier related issues such as milk quality standards, differential payments, financing options etc with a board member and company employee. The second meeting is for education and training on subjects such as financing, how to read and interpret a balance sheet, yield on investment, making provisions for acquisitions etc. While all district representatives attend a training day each year, the groups are kept to a maximum of 45, and representatives from each district are intentionally mixed. Ten to 13 training days are held each year.

- The 27 member co-operative council receives the same presentations as the board regarding budgets, strategy, performance results and acquisition plans. This provision of information is constitutionally required, however it also fits the communication and training philosophy that Campina has adopted.
- A fortnightly magazine is distributed to all members. This is produced by a journalist, rather than being an internal publication, to provide a degree of balance and independence. "It is not a hallelujah magazine. We encourage members to participate and question and challenge the company." Each publication features a farmer interview or discussion with Campina's chairman, chief executive or such like. An independent readership audit is conducted every two years.

Campina Melkunie spends money and time on member communication and training. It is seen as absolutely essential to retain member commitment to the co-operative, and in a rapidly changing environment speeds decision making.

5.2.9 Summary

Campina Melkunie is very much a 'co-operative', dedicated to understanding and serving the interests of its members. The co-operative philosophy is imbued throughout the organisation from the corporate mission statement to communication and consultation with members.

Campina Melkunie is using its 'co-operative' status to differentiate itself as an economic alternative for dairy farmers' milk. Currently this is retaining and expanding co-operative membership, but it could also prove beneficial if Campina Melkunie was to increase critical mass by way of mergers or expanding membership, within the Netherlands or internationally.

New entrants to Campina Melkunie contribute additional capital to the non-allocated general reserve built up via retentions. This capital contribution is not redeemable but is the price new members are prepared to pay for the security of milk collection and payment, and the opportunities for collectively adding value to their milk that co-operative membership provides.

Co-operative membership was offered to German suppliers of MKW in 2000. Campina Melkunie could expand via further international membership, increasing critical mass while retaining its co-operative nature.

Considerable resources are devoted to member communication, education and consultation. This is viewed as an 'investment' in member commitment and loyalty by ensuring that members' appreciate the benefits of a co-operative, understand and 'buy into' the strategy, and that Campina Melkunie co-operative reflects the aspirations and farm-based needs of its members. The turnaround in communication policy was the result of bitter experience in losing members due to a perceived dictatorial attitude to members; a situation that weakened the company.

Campina Melkunie has a dual strategy. The historical 'cost leadership' strategy is being continued to maintain competitive advantage within the EU and for Third Country exports. The priority is to increase the proportion of members' milk sold within the valuable but intensely competitive EU market. Therefore the 'differentiation' strategy of branding and product development is intended to grow the value of Campina Melkunie members' milk by increasing market share and operating margins within the EU. The Benelux and German markets are seen as a natural extension of the Netherlands domestic market. Acquisitions there have provided brands and market share for members' milk. Contract suppliers can be cancelled once their contracts expire.

Members supply Campina Melkunie's equity capital in the form of retention for a non-allocated general reserve and in recently introduced compulsory 'member participation units' contributed in proportion to supply. Additional capital is required to implement the strategy and Campina Melkunie persevered until members agreed to support the strategy with their capital. The MPU's are a form of loan, and members receive a higher than market rate return on this capital, paid as a bonus on top of the milk price. The market-based interest rate paid for voluntary members' capital retained the co-operative characteristic of distributing the operating surplus as milk price. This ensure that the co-operative's focus continued to be on adding value to members' milk for the benefit of members. The 'milk price' includes a return on the general reserve and is dependent on the performance of the co-operative.

Campina Melkunie has all of the distinguishing characteristics of a co-operative with respect to milk intake strategy, ownership and control, and determination and destination of 'operating surplus'. Campina Melkunie is 'co-operative to the core' and is committed to retaining its co-operative purpose and philosophy for the benefit of members.

5.3 Friesland Coberco Dairy Foods

5.3.1 History

Friesland Coberco Dairy Foods (FCDF), based in the north of the Netherlands was formed with the 1997 merger of four co-operatives: Friesland Dairy Foods, Coberco and two smaller predominantly cheese co-operatives Tweek Provinciën and Zuid Oost Hoek. The co-operative owner of FCDF is “The Seven Province Dairy Co-operative”.

Friesland Coberco processes over 5 billion kilograms of members’ milk and is the largest dairy company in the Netherlands processing over half of the Netherlands’ milk. Seventy percent of turnover is generated within the European Union with commodities and branded products. The remaining thirty percent is derived from Third Country markets, often based on commodities sold at a much lower price. FCDF has historically had a ‘cost leadership’ strategy and an international focus through Friesland Co-operative, particularly in South East Asia.

Friesland Coberco Dairy Food Holding Company’s business activities are carried out by eight fully integrated, autonomous operating divisions within two subsidiaries. The operating companies have been grouped by product category within the Friesland Western Europe subsidiary and the other subsidiary, Friesland International, is responsible for all markets outside Western Europe. This structure is expected to provide enhanced market focus and response, improved operational efficiencies, synergies and accountability.

Friesland International now markets very little member milk due to the high cost of EU produced milk. Instead product is bought on the world market or sourced within the local market. FCDF owns manufacturing plants in Asia, Africa and South America in addition to those in Europe.

5.3.2 Strategy

In 1997 Friesland Coberco revised their strategy with significant changes. A “cost leadership” strategy relying on commodities was no longer appropriate in an environment of reducing export subsidies and increasing competition within the valuable, protected EU.

Friesland Coberco’s strategic priority is to increase market share in current and future EU markets, concentrating on Western Europe. Investment in the

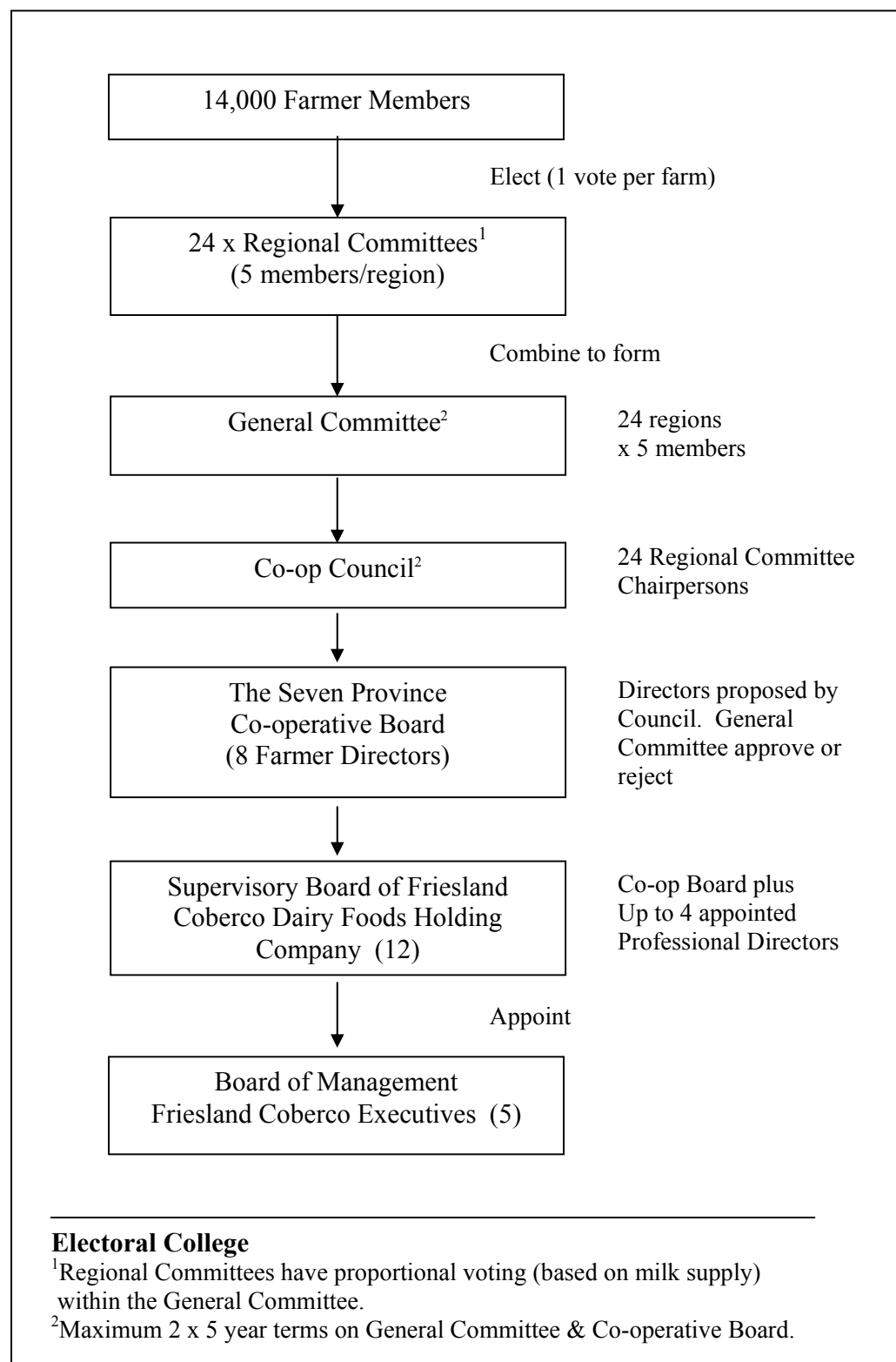
development and marketing of differentiated branded products for the top end of the consumer dairy food market is the focus.

A concurrent strategy is to expand market share in selected emerging dairy markets outside the EU by using brands and new products and technology, either independently or with local partners. Again the focus is the top end of the market. Friesland Coberco has invested heavily in Third Country markets. Twenty-seven percent of Friesland Coberco's sales revenue in 1998 was generated from Third Countries (compared to nineteen percent of Campina Melkunie's). Southeast Asia is a key region for Friesland Coberco, where they have significant presence in branded consumer products.

By focusing on the 'top end' of the markets it targets, Friesland Coberco's strategy is to increase profits through growing operating margins (value of sales) rather than by increasing turnover (volume of sales). "Branding" and operating margin are key to adding value to members milk and generating an operating surplus.

This change in strategic direction has resulted in structural changes to the co-operative as discussed later.

Figure 3: Friesland Coberco Representation and Governance



Friesland Coberco also has a multi-tiered electoral college structure for representation and governance.

Friesland Coberco's 14,000 farmers elect representatives to 24 Regional Committees, responsible for local issues and representing their region at General Committee. Voting is one vote per member irrespective of supply. Regional Committee's combine to form the General Committee, comprising 120 people. The Regional Committees have proportional representation based on milk supply when voting at the General Committee.

The General Committee is the member representation body with the constitutional right to:

- approve or reject Board members proposed by the Council,
- approve or reject proposals put forward by the Co-operative Board of Directors,
- ultimately dismiss the Co-operative Board through a vote of No Confidence.

The General Committee meets five to six times each year for updates and training on finance, strategy, performance and co-operative issues.

The Chairs from each of the 24 Regional Committees form the Co-operative Council. The Council is the communication link between the commercial entity and co-operative members, responsible for communication and consultation with the co-operative membership. The Co-operative Council proposes Board members for approval by the General Committee. The Council is well informed on member and commercial issues.

Friesland Coberco's Co-operative Council and General Committee do not have the same scope or authority for approval and influence in their co-operative as Campina Melkunie's equivalents: the Co-operative Council and Members Council.

5.3.3 Governance

The Co-operative Board comprises eight farmer directors. The Board meets monthly and is responsible for co-operative issues including ownership, financing, the milk price and conditions of supply. The Co-operative Board appoints up to four professional directors to join them as the Supervisory Board of Friesland Coberco. The Supervisory Board meets quarterly and governs the commercial entity: appoint and govern the Board of

Management, approve the annual budget, strategy, annual report and significant business proposals, monitor performance and compliance.

Individuals can serve a maximum of two, five-year terms on either the General Committee or the Co-operative Board. This ensures a balance of fresh ideas and experience on both the General Committee and Board and encourages a degree of stability at the same time as managing succession issues.

5.3.4 Communication and Education

Friesland Coberco holds two rounds of shareholder meetings each year. Forty-eight meetings are held – two locations per region, or approximately one meeting per 300 members. Despite this “take the meetings to the farmers” approach, 35% of members attend Friesland Coberco meetings compared to Campina Melkunie’s 60% member attendance. One meeting is to present the annual accounts and the other is a more general update.

Like Campina Melkunie, Friesland Coberco focuses on training and education of their members. The training is aimed at young farmers, particularly those under 35 years old. Topics include financing, markets and commercial performance and issues.

Friesland Coberco provides a good demonstration of how a change in strategy and philosophy can influence a co-operatives structure and character.

5.3.5 Ownership and Control

The Seven Province Co-operative is the sole owner of Friesland Coberco Dairy Foods Holding Company. FCDF Holding Company subsidiary operating companies are Friesland International and Friesland (Western Europe).

If/when outside capital is introduced to Friesland Coberco Dairy Foods Holding Company, investors will be involved with both member and non-member milk activities. The co-operative will initially retain the majority shareholding, but that could diminish with time. While the majority of members’ milk is sold through the operating company focused on Western Europe, the co-operative also owns Friesland International. This also offers a potential conflict of interest between co-operative members and outside investors.

The equity held in reserves by the four co-operatives prior to the formation of The Seven Province Co-operative has been converted to A shares, representing the collectively owned unallocated equity. Individual shareholders have no claim on A Shares.

In 1994, Friesland Co-operative broke with traditional co-operative financing by 'delinking' the proportional relationship between milk supply and capital supply when they created B shares (up to 49% of co-operative equity). This voluntary capital contribution was designed to generate additional finance for Friesland (to implement its strategy), without compromising the 'control' by co-operative members in proportion to milk supply.

The co-operative certifies the B shares and individual shareholders can purchase the certificates thereby investing capital indirectly in Friesland Coberco to receive a dividend on that capital. Certificates are only offered to current and retired co-operative members and do not carry voting rights. B share certificates can be traded six times each year on an internal market.

The Seven Province Co-operative has three types of members: milk supplying; milk supplying and B certificate holders; and certificate holders ('dry' shareholders). At this stage members who voluntarily provide capital have no voting rights. This could cause future conflicts of interest.

As a means of raising additional finance, B share certificates have been of limited success. The initial offering of B share certificates in 1995 was at 100 Dutch guilders (NZ\$100) per certificate. The level of demand for B shares was less than expected, and subsequent trading was sluggish resulting in a drop in value to 70 Dutch Guilders per share – well below the initial offer price.

Friesland Coberco has adopted this capital structure, originally introduced by Friesland Co-operative. In 1998, as a result of the merger of four co-operatives to form Freisland Coberco, 300,000 shares were offered to all co-operative members. Management proposed a share value of 140 Dutch Guilders per share. However the offer price established by the Co-operative Board was 122.40 Dutch Guilders per share, the closing price of the previous internal trade. By the close of 1998, B shares were trading at 160 Dutch Guilders. These two attempts to raise capital voluntarily from members failed to generate the anticipated finance and Friesland Coberco had to resort to institutional investors for subordinated loans. Milk quotas restrict Dutch dairy farmers' milk growth opportunities. 'Investing' in FCDF was not widely supported by members as an opportunity to 'grow' their business portfolios.

In Autumn 1999, the Management Board was getting ready to discuss the possibility of sourcing external capital from 'investors' with the Co-operative Board and General Committee. They proposed a minimum co-operative shareholding in Friesland Coberco of 51%. From management's perspective, these discussions were unsuccessful. To date (2002), the co-operative and its members have rejected suggestions of 'outside' equity.

5.3.6 Milk Intake

Ten years ago, Friesland Co-operative struggled to get the milk volumes it required to achieve plant utilisation in the Netherlands (cost leadership) and to implement their international strategy of exporting milk to Third Countries with export subsidies. A milk price premium (approximately 4%) encouraged new member suppliers in the Netherlands and contract suppliers from neighbouring Germany.

FCDF revised their strategy to one of 'differentiation' as previously mentioned. Friesland Coberco has made a complete turnaround toward milk pricing and intake strategy since 1997.

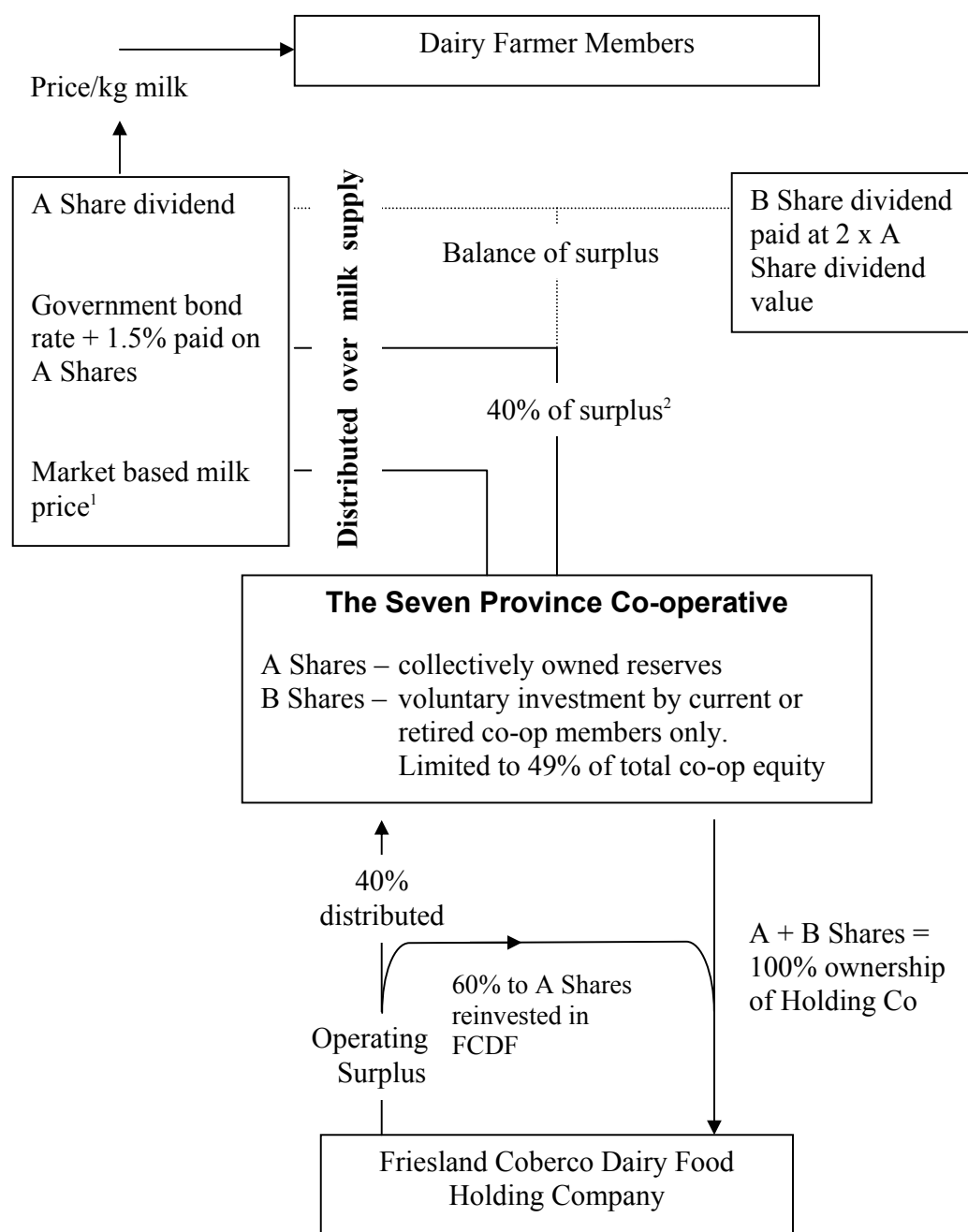
The 'milk price' received by members is now a competitive market price, based on that paid by other large Western European co-operatives.

As Friesland Coberco sells a higher proportion of its milk in commodities than these other co-operatives, the milk that goes into commodities 'cost' the company potential profit. Consequently, Friesland Coberco's strategic priority is to add value to members' milk only, through gaining market share at the top end of the EU market with differentiated, branded products and an associated reduction in the proportion of members milk sold as commodities. FCDF does not want any new milk. In 1998, German contract suppliers, whose raw milk was being imported, were told that their contracts would not be renewed.

5.3.7 Determination and Distribution of Surplus

As illustrated in Figure 4 (Friesland Coberco Capital Structure) farmer shareholders receive three, potentially four income streams:

1. Market-based milk price;
2. Fixed interest rate on A Shares;
3. Dividend on A Shares dependent on remaining profit;
4. Farmers who own B Share certificates also receive a dividend on their B Shares dependent on remaining profit.

Figure 4: Friesland Coberco Capital Structure**¹ Milk Price**

The market milk price is determined by the average percent change of the five large Western European Co-ops indexed to the 1996 Friesland Coberco milk price.

² 40% of Profit Distribution

A shareholding \$ x (government bond rate + 1.5%). The balance for dividend payment on A and B Shares

Market Based 'Milk Price'

When Friesland Coberco offered members voluntary (indirect) investment in Friesland Coberco, milk was assigned an arbitrary value so that it could be treated like any other raw material in order to determine a 'profit' for distribution. Consequently 'milk price' is not based on the performance of the company.

Friesland Coberco's milk price is determined by the relative change in milk price of five other Western European co-operatives, indexed to a base price. The co-operatives used are MD Foods in Denmark, Belgomilk in Belgium, Nordmilk and Humana Mikchunion in Germany and Campina Melkunie in Netherlands. The milk prices paid by the co-operatives are compared to their milk prices in 1996. The base price is the milk price paid by Friesland in 1996 (75 Dutch cents per kilogram of milk). The average percentage change is then multiplied by the base of 75 cents per kilogram to determine the milk price paid by Friesland Coberco.

Distribution of 'Operating Surplus'

Retained Earnings:

60% of the net income is reinvested in Friesland Coberco, by the co-operative. These retained earnings are added to the reserves and are included to the value of the A shares. At this stage members have no claim on the A shares and this 'permanent equity' is owned by the co-operative.

Dividend on A shares:

Forty percent of the net income, after paying for milk is paid to the co-operative. The A shareholding receives a return on capital of the government bond rate plus 1.5%. Once this cost of capital is deducted from the net income, any balance is divided over the A shares and twice the number of B shares. The interest and dividend to A shares is then divided over the milk supply and added to the milk price.

Dividend on B shares:

B shares receive twice the dividend per share that A shares receive, however B shares do not receive any 'interest'. The dividend on B shares is paid to members who own the certificates.

Differentiating between milk price and return on capital is a very complex process!

Friesland Coberco Dairy Foods has to collect, process and market members' milk. This is a prerequisite for the co-operative company, so the priority is to add value to 'members' milk. Hence the strategic focus on gaining market share at the top end of the market with differentiated, branded products, and an associated reduction in commodities. Friesland Coberco is not interested in processing and selling non-member milk within the EU until it has developed EU markets for members milk. Terminating contract supplies to the co-operative company, in the order of 15% of total supply, enables FCDF to add value to members' milk.

Friesland International, the non-EU market focused subsidiary of FCDF, markets very little member milk as its 'cost' is too high. Product is bought on the world market or sourced in the country or trading block it will be sold in. Third Country exports have become the market of last resort.

5.4 Summary of Friesland Coberco

Friesland Coberco does not have as strong a commitment to the co-operative philosophy as Campina Melkunie does. While they have an electoral college and similar representation and governance structures, the member representative bodies do not have the same authority and influence within the co-operative.

Changes in the 'market' have resulted in a significant change in FCDF's strategy and that has resulted in considerable structural changes in both the operating company and the co-operative. In terms of milk intake strategy and determining and distributing the operating surplus, Friesland Coberco is moving away from a co-operative towards the structure and behaviour of an 'investment' company

FCDF is starting to behave like an 'investment' company with an emphasis on maximising the return on capital. The arbitrarily determined 'milk price' provides a means of differentiating between the returns for milk as distinct from the returns on capital. Improvements in FCDF operating performance is not used to increase the payment for members' milk. FCDF 'operating surplus' is distributed as a market based interest for non-allocated reserves and any residual profit is then paid as a return on capital to 'investor' shareholders.

The changes made to FCDF determination and distribution of operating surplus have irrevocably altered the co-operative nature and purpose of the co-operative. The market based milk price denies members the opportunity to increase the payment for their milk.

The risk for milk supplying members, as indicated by the recent unsuccessful proposal to sell shares in FCDF, is that 'outside' capital will be invested directly in FCDF in the future. If this occurs, The Seven Province Co-operative and its members' ownership and control will be gradually eroded. FCDF emphasis and focus is aimed at satisfying the expectations of investors rather than meeting the needs of milk supplying members.

6 Ireland

6.1 Background

The Irish dairy industry has a lot in common with New Zealand's dairy industry. Milk supply is very seasonal, with most cows calving in spring in order to produce as much milk as possible from grass. Dairy plays a significant role in the Irish economy, contributing 5% of GDP. Ireland enjoys the lowest cost of milk production within Europe.

On a negative side, plant utilisation is the lowest in Europe. Ireland's peak to trough ratio is over 5:1 compared to an EU average of 1.3:1. Like New Zealand, Ireland has a small population (3.7 million). Ireland 'exports' 80% of its total milk production.

In 1998, 68% of export sales in terms of value went to Intra-EU countries – 24% to the UK and 44% to the Other EU countries. While Ireland has diversified into some very successful products such as cream liqueurs, it is still largely a commodity producer of butter, cheese, SMP and casein. Two thirds of Ireland's milk is processed into undifferentiated butter and powder. This is attributed to a continuing reliance on seasonal milk supply. Less than half of Irish dairy exports are branded. The Irish Dairy Board is a voluntary equivalent of the (ex) New Zealand Dairy Board. The lack of brand power of the Irish Dairy Board is indicated in the plc's reserving it as an outlet of last resort since they have acquired their own distribution networks.

The Irish dairy industry boomed when Ireland joined the EU in 1973. This offered minimum prices through intervention measures, free access to the valuable European market and export subsidies to Third Countries. Not surprisingly, milk production increased by 37% between 1973 when Ireland gained EU membership and the introduction of quotas in 1984. Within the European milk quota regime, Ireland has negotiated some favourable concessions, the latest being an additional 1.5% quota increase for the country in the CAP II Reform (1999). This is causing UK dairy farmers some consternation as they believe the additional product will land on UK supermarket shelves. Deciding who should benefit from this quota increase is also causing great debate within Ireland, although it is expected that 'young' and 'small' farmers will be the recipients.

Ireland has 35,000 dairy herds, with an average of 37 cows producing 4,500 litres per cow. The 1999 milk price is equivalent to approximately NZ\$9.00

per kilogram milksolids (IR£1.08 per gallon). Milk quota is linked to land so cannot be sold separately. Ireland produces about 5.1 million tonnes of milk, which is processed by 12 dairy entities. The four largest dairy processors are the three plc's (publicly listed company) and Ireland's largest co-operative, Dairygold. They manufacture 66% of Ireland's milk supply. Supplier transfer between dairy entities is negligible, possibly due to an unofficial 'understanding' between the different processors. Half of Ireland's milk is processed by co-operatives (1 large and 25 very small) and the other 50% is processed by three plc's. Dairygold Co-operative is credited with setting the milk price. Dairy farmers are reluctant to see any more of their industry converting to the plc structure. Their concern is the influence of outside investors, and any weakening of the co-operatives.

The need for dairy industry rationalisation and product diversification was commonly talked about 10 years ago, and the issue is still topical today. Progress is negligible, suggesting that dairy farmers' incomes are satisfactory enough to enable parochialism, dairy industry politics and reliance on intervention and commodities to prevail. An Irish Farmers' Journal article estimated the gains to be made from rationalising the dairy industry at a 10% improvement in milk price. Industry studies suggest that Ireland would be best served by just two dairy companies in order to have the scale and efficiency to be 'world class players'. Ireland currently has 29 dairy companies. There are about 30 milk driers, most at least twenty years old in Ireland with a total capacity of 95 tonnes per hour. This is in stark contrast to the new milk driers installed in New Zealand, each capable of 23 and 25 tonnes per hour. New processing factories were built in the 1970's to accommodate the rapid milk growth resulting in EEC entry but little has been invested in plant since then. Carbery Milk Products, a co-operative based in County Cork has chosen a niche strategy and invested £6m in a 2–3 tonne per hour milk drier. This will be used to produce specialised products.

Farmer representative organisations have a policy of 'ensuring the survival of the small family farm'. Ireland and France are renowned within the EU as having the most effective farmer lobby organisations; both are very effective in their own country and at EU level. Many farmer representatives and executives of The Irish Farmers' Association and other agricultural leaders admit privately that farm rationalisation and de-linking quota from land would make the Irish dairy industry more efficient, but this stance is politically unacceptable to their many small farmer members and voters. The Irish Government views milk quota from a social perspective and has the highest intervention strategy within Europe. Until the emergence of Ireland's 'Celtic tiger' economy in the early 1990's, Ireland had a serious unemployment problem. A study in County Clare, in the west of Ireland showed that 1 million gallons of milk quota was equivalent to 80 jobs. One third of Ireland's population lives in Dublin and if people continue to migrate to Dublin from rural Ireland, Dublin will 'seize up'. Through the

Irish Development Authority (IDA), the Irish Government attempts to encourage prosperity throughout all of Ireland. To encourage businesses to establish in smaller towns and rural areas, 'new' businesses are given grants and tax concessions. These examples illustrate Ireland's rationale for and commitment to maintaining the rural population and prosperity. It is conceded that the social aspect of milk quota administration is "holding back the efficiency of the Irish dairy industry". Current debate regarding de-linking milk quota from land will probably result in modifications, but it is likely to remain regionalised to some extent. The absence of family farm successors or 'willing' successors will result in natural attrition of the small family farm in time. There were 60,000 dairy farmers in 1984, now at 35,000 and this is predicted to drop to 20,000 by 2010.

The Irish Farmers' Journal is Ireland's leading agricultural publication with the motto "fearlessly on the side of the farmer". In the lead up to CAP Reform II, editorial policy was strongly against the reduction of subsidies, and the removal of supply control. Journalist, Mr Joe Rae was sent to New Zealand to expose the realities of farming at world prices and 'free market agriculture'. His articles in The Irish Farmers' Journal were also used as the basis for a 'discussion' document "Globalisation in Agriculture". These articles included New Zealand examples of "100 cow herds qualifying for dole payments", "devastated rural villages and poor farmer living conditions, apart from the most exceptional", "farmers running faster to stand still" and "farmers living a cloistered existence without monasteries and convents". It was fascinating to see how New Zealand's free market agriculture was used as 'vested interest' propaganda to maintain the status quo in Europe. While the Church leaders were quick to endorse the discussion document, many leading Irish policy analysts, economists and farming leaders were not prepared to be associated with it.

Due to the introduction of milk quotas in 1984, Irish milk growth is static. As mentioned, milk transfer between dairy processing firms is minimal. As pointed out by Mr Joe Rae, "this end to organic growth posed the risk of either business stagnation or contraction. Overseas expansion into processing, distribution and diversification became the fashionable direction for development." For the plc's in particular, and the co-operatives to a much lesser extent, capital was invested to diversify away from the Irish base of operations, and even away from the original core dairy business. In other words, the capital raised was not used to add value directly to Irish milk through product development or upgrading of dairy plants.

The unique "Irish Model" emerged in 1986 when Kerry Co-op adopted the mixed cop-plc company structure, and listed on the stock exchange. Despite widespread interest in this model, it has not been copied outside Ireland. A case study into the history, evolution and performance of the mixed

co-operative/plc companies and the outcomes for the Irish dairy farmers' provides some valuable lessons for New Zealand dairy farmers.

6.2 Kerry Group “The Irish Model” – A Case Study

Kerry Group is a plc (publicly listed company) that was formed in 1986. Kerry Co-op sold the assets to Kerry Group, and the co-op became an investment holding company. The ‘Kerry Model’, has been copied by other dairy co-operatives in Ireland and has often been held up as a model for the New Zealand dairy industry to adopt.

The decision to list was not born of an ideology of ‘unlocking shareholder wealth’, rather it was a pragmatic, management driven approach to achieving stated business objectives. The need for a rapid change in strategic direction was brought about by the imposition of EU milk quotas, effectively capping milk supply and stalling supply-based growth aspirations. It is clear that once the need for change was recognised, Kerry Co-op management strongly preferred the plc structure as a means to implementing their ambitious diversification strategy. The financial climate at the time also contributed to the preference for a plc structure.

The history of the formation of Kerry Group illustrates the environment and challenges Kerry Co-op faced and highlights the factors that led to the formation of Kerry Group. More importantly this case study demonstrates that the “Kerry Model” is not an appropriate structure for the New Zealand dairy industry and highlights some restructuring options that destroy a dairy co-operative.

6.2.1 Kerry Co-op Formation 1974

Kerry’s farmers were restricted to supplying butter creameries. This was unsatisfactory as there was no market for their whey and the commodity butter prices were very volatile. Consequently it was decided that a casein manufacturing plant was required in County Kerry. Making this aspiration a reality required considerable politicking and persuasion to unite the dairy farmers and to source the necessary capital. Capital was obtained from shareholders, the Irish Development Authority (in the form of a grant) and banks. Before construction started, it was decided to increase the size of the plant from that originally planned. This, and inflation resulted in higher costs than forecasted.

The co-operative began as a private company, North Kerry Milk Products, (subsequently became Kerry Co-op) formed in 1972. The three shareholders were the State-owned Dairy Disposal Company (42.5%), a Federation of

small dairy co-operatives (42.5%) and Erie Casein Company (15%). Erie Casein, based in the United States guaranteed an export market for the casein.

Denis Brosnan was appointed the General Manager. Hugh Friel (Chief Accountant) and Denis Cregan (Production Manager) joined Denis Brosnan's team from the start. The legendary success of Kerry Group is largely attributed to the ability of these three people. They remain the top three executives of Kerry Group. In this chapter, the term "Management" is used to reflect the combined input of these three executives.

Kerry Co-op was formed on 1st January 1974 when approximately 6000 dairy farmers in County Kerry put up £1million in £1 shares to buy the North Kerry Milk Products shares and independent facilities owned by the Dairy Disposal Company and the Federation. These assets and the milk supply of the ten co-operatives in County Kerry were amalgamated in Kerry Co-op. This was no mean feat. Eire Casein retained 15% ownership of the newly formed Kerry Co-op, until they were bought out in 1984.

Kerry Co-op was unusual for Ireland in that it was solely a dairy co-op. Most Irish co-ops are multi-purpose, based on the Plunkett (founder of Irish co-operative movement) ideal of co-operatives as a means of generating regional rural prosperity.

Despite initial funding problems, Kerry Co-op performed very well from 1974 until 1978.

Table 1: Kerry Co-op Performance 1974 – 1978 Period of Early Growth

	1974	1975	1976	1977	1978	Annual Average Change
Milk Intake m gallons	64.5	69.9	77.4	86.0	98.0	13%
Turnover £,000s	20,748	31,139	36,941	48,809	62,429	50%
Operating Surplus £,000s	673	1,542	1,986	2,645	3,604	109%
Milk price P/gal	24.32	31.51	36.03	49.05	53.53	30%

As can be seen from Table 1, Kerry Co-op had a steady increase in milk supply offering organic growth. This growth was predominantly from

members. The suppliers increased their average supply from 7500 gallon to 12,000 gallons over the four years; an increase of 60%. Kerry Co-op also purchased three small, private liquid milk companies and poached suppliers from other companies to improve throughput and operational efficiencies. This sparked off the “milk wars”, both in the supply of raw milk and market share of liquid milk. Management themselves admit that these milk wars distracted their focus on the business, however the table shows that business performance and milk price still grew at impressive rates. Ireland joined the EEC (European Economic Community) in 1973 and all Irish dairy companies subsequently enjoyed unprecedented returns and milk prices due to subsidies, the expanded market and common market prices. Kerry Management are proud to point out that they made consistent profits during the boom years of joining the EEC.

6.2.2 Kerry Co-op Faces a Reduced and Capped Milk Supply

In anticipation of continuing milk growth, Kerry Co-op expanded the Listowel plant to increase processing capacity by 50%. A combination of Tb and brucellosis, wet weather, alternative employment opportunities in the County and the introduction of quotas resulted in a declining rather than expanding milk supply. Kerry Co-op never attained 20% of its projected milk supply.

The Irish dairy herd was infected with bovine brucellosis and Tb. This was a barrier to exports. In late 1978, a national campaign to eliminate brucellosis and Tb was initiated with a pilot scheme in County Kerry. Mandatory blood testing and culling of positive reactors was introduced. Thirteen percent of the cows in County Kerry tested positive. County Kerry’s dairy herd was reduced by 15% by 1981. While farmers were compensated for culled animals, it took time to rebuild the County herd. For the farmers of Kerry and Kerry Co-op, this was unfortunate timing as EEC milk quotas were introduced in 1984, based on 1983 production. By 1983, Kerry Co-op was still only producing 104 million gallons. In 1999 Kerry Co-op had a milk quota of 110 million gallons.

6.2.3 Kerry Co-op Diversifies Out of Milk 1978–1985

After the Tb experience and faced with a reduced milk supply that was soon to be capped by quotas, the Kerry Co-op management saw a total reliance on milk as the primary raw material as limiting the growth of the business. By national and international standards Kerry Co-op was a small company. It processed 10% of Ireland’s milk. Kerry Co-op’s dairy business by volume equates to about four Tatuas. These figures are largely unchanged today due to the restrictions caused by milk quotas.

The threats and risks experienced as a result of the 20% shortfall in milk supply were a challenge that Kerry Co-op managed their way through successfully. Many Irish agribusiness analysts believe that this period of Kerry Co-op's evolution was instrumental in shaping the top three executives business approach of formal strategic planning and a company culture of shared clarity of purpose. It also influenced their attitude towards debt and financing. This became apparent in later years when Kerry management opted for organisational and financing structures that retained total management control within the business.

Denis Brosnan's most frequently quoted attribute is his 'vision'. In the early eighties, Brosnan foresaw the impact of quotas and believed that Kerry Co-ops future lay in diversification into 'value-added' activities, and in becoming a large scale, international food company. Continually improving shareholder returns could only be achieved through merging with another co-operative or diversification. Experience indicated that organic growth from existing, largely commodity businesses would achieve a maximum of 5–6% annual growth.

This resulted in the 1980 Board endorsed corporate objective of *“building a profitable and growing business in food and agricultural activities thus providing our farmer shareholders with continually improving returns”*.

Between 1979 and 1985, Kerry Co-op embarked on diversification activities, many of which involved acquisitions. Within Ireland Kerry Co-op diversified its raw material moving into pig meats and non-member milk, and diversified its market categories by moving into consumer branded products in meat, liquid milk and chilled dairy products. Research and development became a priority. This period also saw Kerry diversify into the United States ingredients market. An office was opened in Chicago so that Kerry Co-op could develop direct relationships with customers in developing specialised ingredients.

The fundamental motivation for a change in strategic direction was that the shareholders' individual dairy businesses and therefore Kerry Co-op had limited organic growth options imposed on their dairy businesses with the introduction of milk quota's. Improving returns from a milk business could only be achieved by adding value to a fixed volume of milk. The options for growth from within the shareholders dairy farms were extremely limited or even non-existent¹.

¹ As an aside, Hugh Friel views New Zealand's organic milk growth as a huge positive for our co-operatives

Table 2: Kerry Co-op Performance 1979–1985 Period of Diversification and Acquisitions

	1979	1980	1981	1982	1983	1984	1985
Milk Intake m gallons	82	?	?	?	104	104	104
Turnover £'000's	78,350	79,860	95,658	129,259	158,079	180,470	211,239
Operating Surplus £'000's	3,975	3,021	1,462	4,213	4,307	4,756	5,113
Milk Price P/gallon							

NB: Repeated requests for the missing information yielded very vague answers.

Since 1979's fall in milk supply, Kerry Co-op had been practising successful plc management: moving from commodities into higher margin value adding activities in order to generate continual growth in profits, year on year.

The Board supported the 1984 Management's proposed corporate objective: *"To build a profitable and growing international food organisation thus providing farmers, suppliers and shareholders with continually improving returns."*

The significant changes in the corporate objective were formalising the 'international' focus and the differentiation between 'farmers, suppliers and shareholders'. The expanded corporate objective allowed three options to raise the capital required to fund this strategy:

- Increase the level of retained earnings.
- Seek further capital from existing shareholders.
- Raise outside capital.

The distinction between "farmers", "suppliers" and "shareholders" in the corporate objective indicates that the Board supported the option of 'outside capital' to fund this strategy.

Management's vision and ambitious strategy involving aggressive and rapid expansion internationally through acquisitions would require substantial capital. Kerry Management define their formula for growth in the equation:

$$\boxed{\text{Strategy} \times \text{capability} \times \text{capital} = \text{sustained profitable growth}}^2$$

² The Kerry Way

According to the Kerry formula, sustained profitable growth is a product of the three components, each equally important. If one of the elements is missing, profitable growth will be zero.

In the early 80's, Kerry had a clear strategy. It had been developing capabilities in research and development, and also in identifying and realising potentially profitable acquisitions within the Irish food sector. Kerry's primary limitation for sustained profitable growth was a lack of capital. As a small company it was limited in its ability to borrow the capital required to fund its ambitious growth strategy.

Public speculation on a possible listing of Kerry Co-op started as early as 1982.

6.2.4 Financial Markets Expensive

In the mid-eighties, the Irish economy faced high interest rates (13%-15% per annum), high inflation and a weak Irish punt. Equity capital in this financial environment was less of a financial burden than debt repayments and more importantly had the potential to provide large sums of capital.

Kerry Co-op was only 12 years old. It started with high debt and limited borrowing capability. The financial burden of paying the debt resulting from expanding processing capacity by 50% at a time of diminishing milk supplies put further financial pressure on management. Another attraction of equity capital was that it did not have to be repaid, and the Company could determine the dividend.

Kerry Co-op considered the following financing options:

- Floating 20% of the total Kerry Co-op's business.
- Separating and floating specific Kerry Co-op business activities.
- Direct investment in Kerry Co-op by a Financial Institution.
- Raising additional investment from existing shareholders.
- Off-balance sheet financing, i.e. leases.

6.2.5 "Management Driven" Public Share Issue

By 1985 Denis Brosnan, Hugh Friel and Denis Cregan had earned the loyalty, trust and faith of both the Board and shareholders. They had successfully managed Kerry Co-op through the adversity of a reducing milk supply, and in implementing the diversification strategy had demonstrated an

ability to plan strategically and to grow capability and profitability from new business ventures. A track record of success amid much speculation of imminent disaster by other co-ops served to consolidate the Board and shareholder confidence in Management proposals and commitment to their direction. Denis Brosnan is described as having had considerable influence over the Board.

Denis Brosnan's leadership of Kerry Co-op/Group has led to him being held in extremely high regard within the Irish dairy industry. During my study, people repeatedly quoted him to the point where I felt he has a demi-God status and he invariably received the credit for Kerry Group's success. Hugh Freil and Denis Cregan were frequently mentioned. The contribution of the Board was never mentioned.

The management preferred the option of floating 20% of Kerry Co-op. Business analysts, industry commentators and farmers all told me "the decision to list Kerry Co-op on the stock exchange was Management driven". Despite remarkable growth and performance in the early years, Kerry management experience in having to manage their way through a shaky start meant that they strongly favoured structures and financing options that retained total management control within the business. For example, joint venture and alliance options were quickly set aside in favour of non-controlling individual investors. The advantages of a public listing as presented by Management to farmer shareholders include:

- Floating on the stock exchange was likely to raise the largest amount of money and subsequent floats could raise more capital.
- Equity did not have to be repaid and the Company determined the level of outgoings in the form of dividend.
- All of the business remained in one entity. There would be no debate or controversy determining which activities were co-operative and which activities were investments.
- Management control would be retained over the whole business entity. (It seems ironical that the founding farmers were asked to relinquish part of their ownership of the business entity, so that the management could have total control.)
- Management were concerned that off balance sheet equity (including joint ventures) and investment by financial institutions may be perceived as an indication that Kerry Co-op was in financial difficulty. After the unexpected early obstacles to obtaining loan funds and the perception of a risky (high growth) strategy, this was to be avoided at all costs.

6.2.6 Solutions to Mitigate Reduced Farmer Ownership and Control

The decision to offer equity holdings to non-farmer suppliers was a concern to farmers. Loss of farmer ownership and control was an issue. Solutions to mitigate these concerns were:

- The proposal was to float 20% of the Company, leaving 80% of the publicly listed shares in the farmer-controlled co-operative.
- Subsequent share issues would be limited so that at least 51% of Kerry Group's shares would be held by the co-operative investment holding company, Kerry Co-op.
- The plc board would be the co-op board with the addition of Denis Brosnan, Hugh Friel and Denis Cregan and two 'outside', professional directors. The board would total 20 directors. (This Board size and the success of the Company are in stark contrast to claims within New Zealand, that board size limits commercial governance. Kerry Group's board size and commercial results indicate that clarity of vision, inspirational leadership and commercial management are considerably more important than board size.)

At the time of the float, 30% of Kerry Co-op's shareholders were 'dry' i.e. did not supply milk. They were treated exactly the same as supplying shareholders as reward for risking their contribution to start-up capital, their patience and loyalty.

The floatation proposal put to shareholders at a special meeting in February 1986 was passed. Irish co-ops have a voting system of one vote per shareholder.

Table 3: The Float October 1986

Shares	%	Issue Price	Class of Share	Offered To
72,000,000	80		B	Kerry Co-op*
10,350,000	11	35p	A	Shareholders, suppliers and employees
8,000,000	9	52p	A	Public and institutions

* 1 share in Kerry Co-op is equivalent to 10 shares in Kerry Group (plc)

From issue prices of less than £1 in 1986, Kerry Group shares peaked at £11.11 in 1998, and were trading at £9.70 in 1999 (£12.30 in March 2002).

The initial share issue yielded IR£7.7 million. With this capital and that raised with subsequent share issues, Kerry Group's executive embarked on their 'international food and ingredients' strategy. Denis Brosnan had made the commitment to deliver 15% compound growth in earnings when presenting to potential investors at the time of Kerry Group's initial floatation. This equates to doubling the business every five years. Kerry Group has delivered year on year.

6.2.7 Increasing Loss of Ownership and Control

As Kerry Group shares appreciated, co-operative members became motivated to unlock the wealth in the co-op. In 1993 Kerry Co-op shareholders passed a resolution transferring 5% of the Co-ops shareholding in Kerry Group directly to shareholders. Kerry Co-op shareholders received 10.9 Kerry Group shares for each Co-op share 'cashed up'. This unlocking of shareholder wealth in the co-op wealth was received very positively by Co-op shareholders.

Having very limited opportunities to grow their own dairy farm businesses or even diversify land use due to the expansion restrictions placed on farmers within the subsidised European Union many of Ireland's progressive dairy farmers use the stock exchange as an investment tool to grow their wealth. Michael Murphy, a very successful dairy farmer and businessman is coaching many young farmers. They typically leverage the equity in their dairy farm businesses to invest in non-farming activities. The teachings of Warren Buffett, the investment guru, were frequently quoted.

By 1996, successive stock market share issues had reduced the Kerry Co-op ownership of Kerry Group to 52.2%. Kerry Group had reached its limit on raising equity capital. Having exhausted the share issue options, the Management were once again restricted to borrowings to fund growth, and had reached their debt/equity limit.

Kerry Group put a second proposal to Kerry co-op shareholders in 1996. The package had four components:

1. Transferring 21.4 million Kerry Group shares owned by Kerry Co-op directly to the Co-op shareholders (approximately IR£130 million).
2. A constitution rule change dropping the Co-ops minimum ownership stake from 51% to 20% of the plc's total shareholding.
3. Reducing the number of Co-op directors on the plc Board from 15 to 9 and replacing them with 'outside' directors. (The Board still totalled 23.)

4. Giving Kerry Co-op the option to purchase the Agribusiness Division. This option is open until 2020. The Agribusiness Division includes milk collection, artificial insemination business, the feed mill and a store network.³

This proposal was more contentious and more hotly debated than the initial proposal to float in 1986. Kerry Group shares were worth approximately IR£6 at the time. One Co-op share was worth approximately IR£65. Around IR£130 million was transferred to 6000 shareholders. On average each shareholder received IR£21,500 worth of shares. Many believe this 'sweetener' was a significant influence in farmers' willingness to relinquish their co-operative ownership and control of the plc. The vote outcome was also influenced by the 'dry' shareholders within Kerry Co-op. However, ownership of a controlling share of Kerry Group was one of the few ways farmers could add value to their own individual farm businesses.

Table 4: Kerry Co-op Ownership and Value in Kerry Group

Year	Co-op Shareholding of Plc %*	Value IR£m
1974	100	1
1986	80	31
1996	52	441
2000	37	1035

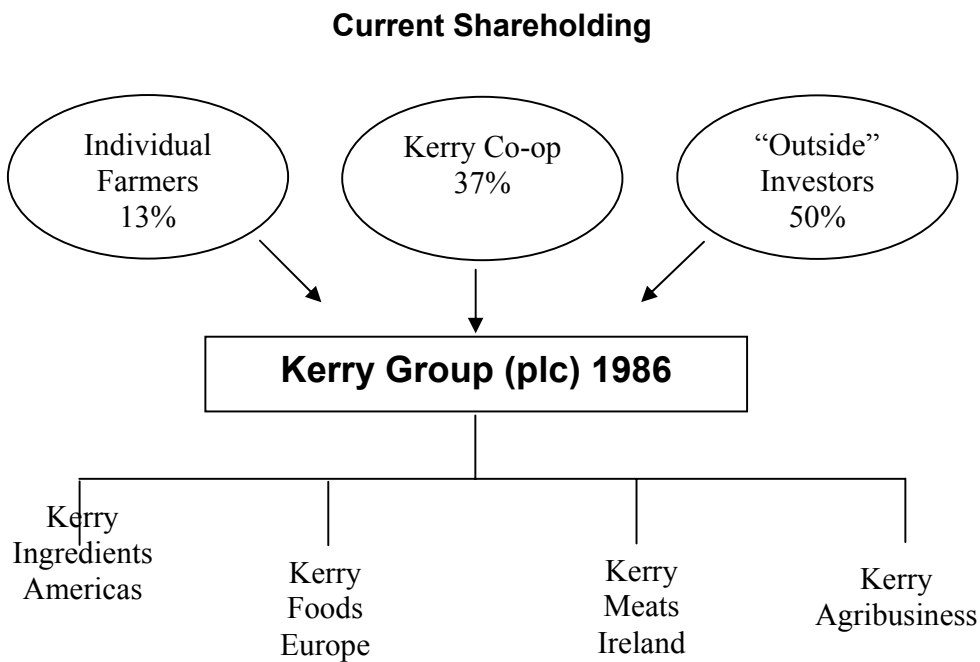
*These values exclude the Kerry Group shares transferred from the Co-op to be owned directly by shareholders - 5% in 1993 and 25% in 1997.

Table 4 suggests that the Irish farmers were better off reducing their 100% ownership in a co-operative with limited growth opportunities and taking a smaller ownership in a diversified, well managed business with sustained profitable growth.

While the farmers supplying Kerry Co-op often laugh that the day will come that they will have to buy back their dairy co-op collection and processing facilities, there is no regretting the decision for Kerry Group to list on the stock exchange. Changing circumstances could change the sense of satisfaction in the future.

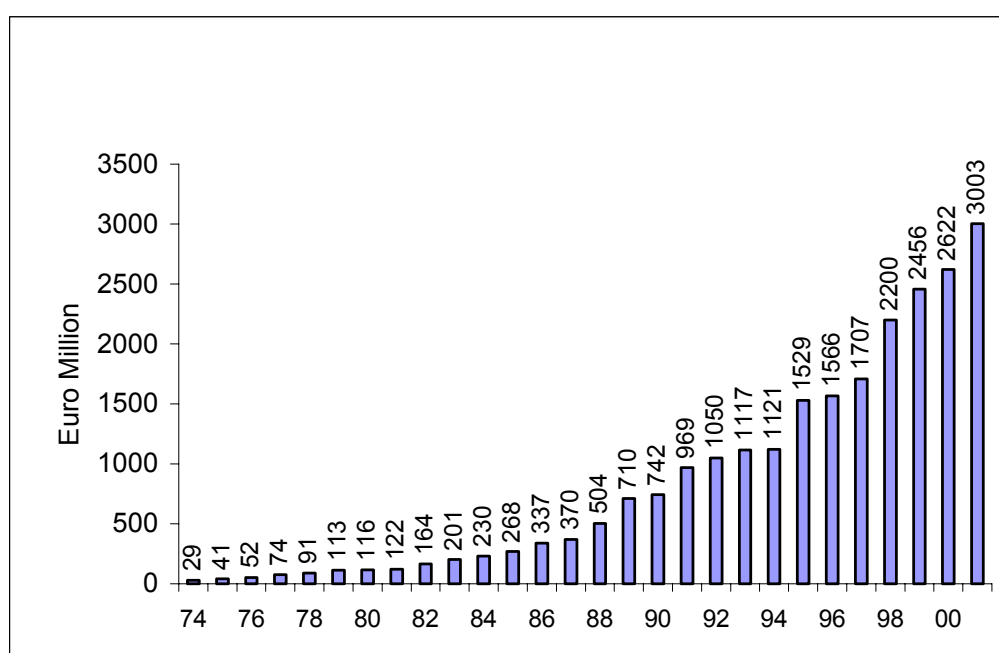
³ Adopting the proposal required at least 75% shareholder support from each of two special meetings held 2 weeks apart. Support at the first and second meeting was 85% and 80% respectively.

Figure 5: Kerry Group Structure and Ownership (1999)



6.2.8 Kerry Group is not a “Dairy” Company

Kerry Group is a very successful company with a turnover of £1.7b in 1998, and consistently increasing annual operating profits and share value by 15% each year. Kerry Group aims to grow its earnings at an annual rate of 15% in each five-year period. This equates to doubling turnover every five years!

Figure 6 Kerry Group Turnover 1974–2000

Kerry Group is an investment company. Their primary objective is increasing share value via sustainable profitable growth. Kerry Group moved out of commodity businesses into value added activities to generate greater profits. Profit margins (operating profit over turnover) have improved from 5% in the 1970's to 8% in 1998 and the target is 10% by 2003. Kerry Group successfully identifies and targets food ingredient and flavourings markets that will contribute to profit.

However Kerry Group can hardly be called a 'dairy' business, as less than 8% of turnover is derived from milk. Kerry Group processes more berry fruits than milk. In the early-eighties Kerry Group made the strategic decision not to be a dairy company, focused on the processing and marketing of a static milk supply.

6.2.9 The Current Situation for Kerry's Dairy Farmers

The dairy farmers belonging to Kerry Co-op consistently receive one of the highest milk prices paid in Ireland. Kerry Group is the fourth largest dairy business in Ireland, processing 520 million litres of milk a year (including 70 million litres bought from other dairies). Kerry has 10% of the Irish liquid milk market utilising 45m litres. The rest of the milk is processed into butter and butterfat products, to generate SMP for casein and milk powders that are then used in their lucrative food ingredients business. Kerry Group is in a good position to pay a high milk price to Kerry Co-op members.

While Kerry pay one of the better milk prices, their milk price is determined by that paid by the Irish co-operatives rather than the returns milk earns from the value-adding ingredients and consumer foods activities Kerry Group is involved in. Kerry Group could pay a higher milk price, but in typical plc fashion pays a 'competitive' market-based milk price. Value is added to milk, but that value is used to boost the value of the Company (share price and dividend) rather than paid to farmers in the milk price.

Ireland's co-operatives set the market milk price that Kerry dairy farmers receive. The Irish Farmers' Journal publishes comparative monthly and annual milk prices paid by all Irish dairy processors. This Milk League keeps the pressure on all of the dairy companies whether they are co-operatives or plc's.

The four largest dairy company's process 66% of Ireland's milk. Three of these companies are plc's and they process 49% of Ireland's milk. Eighteen small co-operatives process 18% of Ireland's milk.

Dairygold is the only co-operative in the "big four" and the second largest dairy company (by milk volume) in Ireland, after Glanbia. Consequently, Dairygold is widely recognised as being the milk price setter for the plc's. Not surprisingly, the dairy farmers who have opted for the mixed plc/co-op structure are very reluctant to see Dairygold change from a co-operative structure. Dairy farmers in Ireland do not want any more co-operatives to go "the plc route", as they will be the ultimate losers in terms of milk price and the opportunity to collectively add value to their milk.

Kerry Co-op members invariably have chosen to buy and retain shares in Kerry Group as independent investors. Farmers individually own 15% of Kerry Group shares and co-operatively own 37%. They consequently have four income streams:

1. A market-based, competitive milk price. 95.45 IR p/gallon in 1998 (equates to NZ\$7.50 per kilogram milksolids).
2. Kerry plc share appreciation and hence capital gain. In 1986 when the plc was formed, shares to co-operative members were 35p each. Thirteen years later (1999) they are worth £9.70.
3. Kerry Co-op share dividend. Members own shares in Kerry Co-op at a nominal value of £1 per share. The Plc dividend to the co-operative in 1998 converted to 50p per co-operative share.
4. Kerry Plc share dividend. This was 5.2p per share in 1998, or 0.5% return on capital.

Needless to say, Kerry farmers are very happy with their Co-op and Plc performance. County Kerry was not one of Ireland's most prosperous farming areas, and as one person said "Kerry Group has made millionaires out of Kerry's dairy farmers".

6.2.10 What is the Future for the Kerry Dairy Farmers?

The view "the farmers have sold their co-operative and you can only sell once.... when its gone, its gone forever" was regularly expressed when discussing Ireland's mixed co-op/plc structure.

Kerry Group is still relatively young. The plc and associated shares have only been in existence for 13 years. There are risks for Kerry's dairy farmer milk suppliers in the future.

Through the co-operative and individually, Kerry farmers own 50% of Kerry Group shares however the majority of these 'farmers' are not milk suppliers. In 2002 over 60% of Kerry Co-op shareholders are 'dry' shareholders, indicating that Kerry dairy farmers own and control only 20% of the Kerry Group shares. As the Kerry Group shares are increasingly separated from the dairy farms, dairy farmers' income streams from, and influence over the plc will be reduced.

The current generation of farmers' has sold their co-operative and the associated ability to collectively add value to their milk. The value added to their milk is shared among the investing shareholders, of which they are 10%. The milk price Kerry dairy farmers receive is largely determined by the performance of Dairygold Co-operative, a company with a higher proportion of commodity products and one they have no influence over.

As illustrated above, the annual income derived from the share dividend is a paltry 0.5% return on capital. The value of Kerry Group shares is in their capital appreciation of approximately 15% each year. The wealth created in the shares owned by farmers can only be accessed when they sell those shares.

The Irish are renown for their strong emotional ties with land. Land sales are rare, with most land being transferred to the next generation. It is common for farm successor siblings to be given Kerry shares as their share of the inheritance, breaking the link between milk suppliers and shareholders.

To date there has not been a conflict of interest between dairy farmers wanting a high milk price and investors wanting a high profit, dividend and share appreciation, but this could change in the future.

Dairy farmer shareholders have the strong support of Denis Brosnan and his top team. I often heard of the management's "commitment and loyalty to its dairy farmer shareholders". They enjoy and value a reciprocal respect and a shared history. Successor management teams will not have this shared history and the same sense of commitment to the initial equity holders. The interests of dairy farmer shareholders are more likely to fall behind those of the majority stock exchange shareholders in future. It is also very possible that Kerry Group will divest the milk processing and agribusiness activities.

It took the Kerry Group management 10 years to float 50% of the business. Of the 30% currently at their disposal, they had floated close to half of that by 1999. The Co-op's share in 2002 is 35% of the plc. The rules that dictate that Kerry Co-op have a minimum Kerry Group ownership of 20% ensure it is currently the majority owner. One can only speculate as to how long this will last and where the Co-operative's ownership will eventually finish.

Kerry Group is no longer a 'dairy' company. Less than 8% of Kerry Group's turnover currently is derived from milk. This raw material comes with all the associated requirements of a co-operative: farmer representation on the board; shareholder communication and consultation; maintaining supplier relations and dealing with 2300 milk suppliers etc.

The 1996 proposal put to Kerry Co-op shareholders included the option of buying the Agribusiness division – milk collection, feed mill and agri-store network. The contribution of this division to Kerry Group's overall performance is minimal. In 1998 Agribusiness accounted for 3% of Kerry Group turnover, 0.6% of profit and a 1.4% operating margin. This is a far cry from the aspired to 10% operating margin by 2003.

I have come to the conclusion that it is highly likely that Kerry Group will divest the Agribusiness and milk processing activities and that the dairy farmers will be given first option of buying them back. If Kerry Group divested the milk collection and processing activities, it could become a key customer for the co-op, buying the casein and commodity dairy products. This association would be similar to Nestle's relationship with the NZMP.

The Kerry Co-op shareholders entity and equity provided the launching pad for Kerry Group. The generation of farmers that sold the co-operative has increased their wealth through the benefits of owning shares in an investment company. It is likely that future dairy farmers will have to buy back the commodity co-operative and invest in value adding activities to

increase the value of their milk. Kerry dairy farmers have certainly enjoyed short-term gain. Only time will tell if they experience long-term pain.

6.3 Three Irish Co-operatives Adopt the ‘Kerry Model’

When Kerry Group was formed, there were plenty of cynics and critics from the Irish co-operatives who expressed their opinions publicly. Within a few years, many of these critics were encouraging and/or supporting proposals for three other Irish co-operatives to list on the stock exchange. By 1990 Avonmore, Waterford (subsequently merged to form Glanbia) and Golden Vale co-operatives had listed on the stock exchange. None of them have been able to repeat Kerry Groups’ phenomenal success.

As one agribusiness commentator said *“Kerry Plc is a very successful company. They have delivered to both shareholders [dividend and share value] and milk suppliers [milk price]. The Group puts incredible pressure on the other Irish plc’s to meet their performance, but Kerry Group is in the food ingredients business which is a different business to that of Glanbia plc and Golden Vale plc.”* This commentator highlights the reality that the “me too” plc’s have not been able to evolve their business to capture the value-added components of the food ingredients sector.

6.3.1 Glanbia plc.

Avonmore plc and Waterford plc were initially floated in 1989, based on the same structure as Kerry Group. Neither performed well on the stock market and very quickly turned to the hope of increasing efficiencies through scale and rationalisation. An initial merger attempt in 1991 failed, but Waterford’s issue of a profit warning (notifying the stock market of anticipated failure to reach profit targets by more than 5%) in 1996 provided the opportunity and motivation to try again.

Farmer shareholders were reluctant to endorse the proposal. ‘Sweeteners’ of a guaranteed milk price for three years, and promises that no major plant closures would occur in Ireland for at least three years, helped clinch the necessary support from the Co-op shareholders. Management also committed to capture merger savings of IR£20m per annum up to 2001. Debt levels within the two plc’s had also become untenable (combined net borrowings of IR£338m at the end of 1997) and it was expected that improved efficiencies and growth would enable the reduction of the significant debt burden. Within a very short time it became apparent that these sweeteners and promises were limiting the Company’s ability to realise its strategy – they were subsequently unilaterally set aside. The promise of no plant closures was broken with the closure of the Dungarvan plant, and

Glanbia became the first milk buyer in Ireland to drop their milk price by 3p per gallon in July 1999. Assurances that Glanbia would keep its promise to pay 3p above (the rest of) the dairy industry weighted price were given. Threats that “failure to do so will result in revolt by the Glanbia milk suppliers”, indicated the farmers sense of betrayal, but their ability to act on the threat was never strong. Milk had to be sold for processing while fresh and an alternative outlet for their milk could not be generated overnight.

Glanbia released their half-yearly results in September 1999. The following three articles from The Irish Farmers’ Journal September 11, 1999 refer to Glanbia’s half-yearly financial results. These articles highlight the reality Glanbia supplying shareholders face:

- loss of ownership does result in loss of control
- conflict between milk price and profitability
- management’s tendency to target milk price as a quick and easy solution to growing profitability
- the pressure to satisfy investor shareholder expectations at the expense of supplying shareholders
- projected earnings and savings are not always achieved
- acquisitions are not a guaranteed route to growth and profitability.

Glanbia at a Glance

By Paul Meade, Agribusiness Journalist
Irish Farmers Journal 11/9/99

- | | |
|---|---|
| • Sales down 8% to £1.1 billion | • Consumer foods suffered a 9.5% fall in sales to £463m |
| • Operating profits down 35% to £35m | • Operating margin in Consumer foods dropped to just 2.3% |
| • Profit before tax and exceptional charges down 45% to £19.4m | • Food ingredients sales dropped by 11.4% to £291m |
| • Earnings per share adjusted fell by 58% | • Food ingredients operating margin fell to 3.4% |
| • Exceptional charges of £73m of which £66m relates to business disposals | • Meat sales dropped to £232m |
| • Total exceptional charges incurred to date top £270m | • Meat operating margin of just 3% |
| • Loss before tax of £53.6m | • Agribusiness sales amounted to £116m |
| • Interim dividend of 2.34p, up 4.5%* | • Agribusiness operating margin of 6% |

* emphasis added

The Glanbia Results

By Matt Dempsey, Editor

Excerpt from the Irish Farmers' Journal, 11 September 1999

Company apologists for the poor financial performance of Glanbia (Avonmore) have apportioned high blame to "excessive" milk price. Not a word was said on management efficiency or on weak decision making.

Avonmore were never high payers in the milk leagues. The promise of a price premium made at the time of the Waterford merger was based on the expected cost savings from that merger. If those savings were not realised the fault may well have been the consequence of weak decision

making. The limited visible evidence is sufficient to generate suspicion.

Glanbia is a publicly quoted company mainly owned by farmers. It has an obligation of efficient management to all shareholders; but its milk supplying farmer members cannot be set aside in current pricing or in development strategy. I note that despite the woes, dividend payments continue to increase.

Exceptional Charges of £270m Post Merger

By Paul Meade, Agribusiness Journalist

Irish Farmers Journal September 11, 1999

The central issue for all those trading with, working for or investors in the Glanbia group is what are the real growth prospects for the group?

Glanbia has now incurred over £270m in exceptional charges following the merger and business disposals. Pre-tax profits for the half-year dropped to just £19.4m, which converts to a loss of £53m when exceptional charges of £73m are included.

In the first six months of this year, Glanbia managed to retain only £3.4m in profits on sales of £1.1 billion. This excludes the exceptional charges.

Farmers, especially former Avonmore suppliers, are finding it very difficult to understand where and how it all went so wrong. Why did the merger promises not materialise? They voted for growth, efficiencies and market positions which would support them in share price and milk price.

The current reality is very different. Major contraction of its businesses and the disposal or closure of virtually all of Waterford's dairy operations.

And even after selling chunks of the "family" businesses, the group is still under pressure with milk price seen as an easy target to appease stock market appetites for growth and the rebuilding of profits.

There is now no mention of the merger savings, estimated at the time at a cumulative of £40m over two years up to the year 2001. It seems that any savings generated have been more than subsumed by over runs on delays in rationalising, a nightmare period of losses/low margins on its meat division and the huge under estimate of the costs and problems in moving the Rathfarnham liquid milk plant.

The three excerpts are chilling reading for any dairy industry contemplating a "me-too" aspiration towards the Kerry Group strategy and success. The poor performance and ineffective implementation of the planned strategy suggests that the merger strategy and business plan was not based on a rigorously analysed and developed strategy nor on Avonmore and Waterford plc's unique business attributes and core competencies. Glanbia plc's management have failed to effectively integrate the businesses to capture savings and implement the growth strategy. The "me-to" approach cannot succeed without the critical factors for success contained within the Kerry Group.

6.3.2 Golden Vale plc.

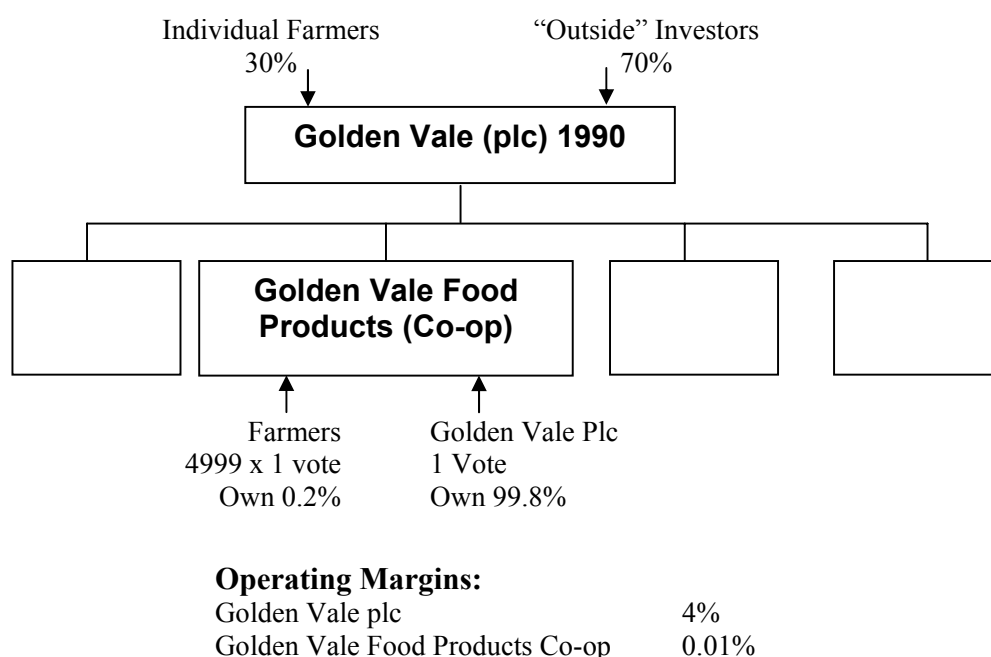
GoldenVale plc was formed in 1990. Golden Vale created a unique structure for their mixed co-op/plc. One that has proven to be far less effective in ensuring that the supplying shareholders retain their majority influence within the Company.

Rather than holding the farmer's shares in Golden Vale plc in a 'co-operative block', they are held individually by the farmers in the same way that 50% of New Zealand Dairy Foods was individually distributed to farmers in New Zealand in 1999.

Golden Vale dairy farmers hold 30% of the total plc shares. Given that not all farmers vote or attend meetings, Golden Vale's farmers have effectively reduced their collective 'vested interest' power and influence within the plc. As indicated in the following articles, the supplying shareholder representation on the plc Board was challenged, and lost.

Golden Vale is also unique in that (GVFP) Golden Vale Food Products Ltd, the founding co-op has become one of the plc's subsidiaries. Golden Vale plc owns all of the subsequent acquisitions and associated debt. As illustrated in the figure, Golden Vale plc owns 99.8% of the co-operative but only has one vote. Conversely the co-op members own 0.2% of the co-op subsidiary, but have 4999 votes.

Figure 7: Golden Vale Plc Structure and Ownership



6.3.3 Structure Adds to Problem of Conflicting Shareholder Interests

Subsidiary company Golden Vale Food Products Ltd manages the milk collection and primary processing facilities, a feed mill, agribusiness stores, artificial insemination and liquid milk businesses. While these are essential for on-farm performance, from a plc perspective they are low profit margin activities. In 1998 these co-op subsidiary activities contributed 44% of Golden Vale plc's total turnover with an operating margin of around 1%. (IR£3m on a turnover of IR£253m in 1998). The Golden Vale company wide operating margin in 1998 was 3.9%. It is very difficult for a plc to meet investor's expectations when a high proportion of turnover is in business activities that generate low profit margins. Golden Vale has had to issue two profit warnings in the last three years, which is indicative of aspirations that currently cannot be met.

The following articles by Paul Meade, Agribusiness journalist, The Irish Farmers' Journal, June 19, 1999 illustrate the reality Ireland's Golden Vale dairy farmer shareholders and suppliers faced in 1999. These articles clearly demonstrate what can happen when a plc is under pressure to satisfy the expectations of investor shareholders. The farmers, having relinquished ownership and control of their co-op to the plc are a very easy target.

Should GV farmers lose their plc control?

By Paul Meade, Agribusiness Journalist
Irish Farmers' Journal, June 19, 1999

Should Golden Vale farmers agree to end the relationship of their co-op Golden Vale Food Products with GV plc?

Some commentators seem to think it's time for farmers to relinquish their board control at GV plc on the basis that they hold only 30% of the shares. Management seem intent on taking things further by proposing to sever the relationship between GV plc and its co-op founder.

The same writers frequently say that the farmer board interests conflict with ordinary shareholders interests through the milk price. Glanbia may have a conflict but theirs is management made via the merger milk price commitment in order to secure the deal.

If such a conflict of interest exists at GV why has this not been reflected in their milk price? Golden Vale has consistently paid lower prices than similar sized businesses. Their farmers have accepted lower prices rather than push for higher prices at board meetings on milk price.

Indeed GV farmers have been very patient with their management and

supportive through difficult times. At the same time they are perceived as the main problem at GV. How can GV plc grow profits unless it cuts milk price? It can if it no longer buys and processes milk.

Recently GV parted with the long standing custom that only those who are elected to the co-op board of management can serve on the plc board.

The spin doctors suggest that this is very bad for the plc in terms of stock market perceptions. This issue never arose in Kerry for the simple reason that Kerry continue to meet profit forecasts and deliver a growth story.

GV was once the darling of the stock market when it too delivered increased profits and a growth story. This ended in 1994 with the now famous profit warning. The spin doctors decided then to blame everything on the farmers and divert attention from GV management's poor overseas investment decisions.

Dublin Consultants Study Structure Reform Options

By Paul Meade, Agribusiness Journalist
Irish Farmers' Journal, June 19, 1999

Golden Vale has engaged a Dublin financial institution to advise on how it might undertake a reform of its structure. A document has been prepared by consultants on the various options open to the plc.

It seems that the main agenda on the minds of top management at GV plc is how to split the co-op from the plc. The company has and continues to spend money sourcing the top legal views on how to take the co-op out of GV plc.

The Journal understands that the plc is attempting to limit the co-ops ability to seek similar legal views. Overturning the GV structure involves a major battle but with significant prizes for the plc. The board of the plc are considering three options on the future of the organisation.

These amount to a demerging of the co-op from the plc and then merging this co-op with another co-op from whom GV plc would hope to get some revenue for the transaction. The second involves selling the co-op back to the farmers and the third is to continue as is – even though this presents major difficulties for the group and its stock market objectives.

The plc must deal with Golden Vale Food Products (the co-op) and its management committee, as no outside party will stump up money to buy the co-op assets and milk processing operations. The unique structure which established GV as a plc ensure that the plc has only one vote despite owning 99.8% of it. This is one vote out of 5,000 held by GV farmers.

Apart from convincing stock markets that GV is no longer yielding to "greedy farmers", demerging the co-op would put GV plc into play as a take over target.

GV plc can only become a take over target if and when it sorts out the

unique GV co-op – plc structure. A take over generally triggers a rise in share price which would increase the value of GV plc shares and the value of share options.

It would not take a genius to guess who would share in any potential pot of gold, or what management sweeteners a take over would throw up.

It must be said that improving the value of plc shares by a co-op split and preparing the way for a possible take over of the GV businesses excluding primary milk processing represents a solid business aspiration to grow shareholder value.

The real trick will be convincing GV co-op members that the move is to their benefit in terms of returning milk pricing policy to the co-op and improving the plc share price of which over 30% of the plc shares are held by farmers. However, the entire exercise is fraught with politics especially since GV milk suppliers have never seen top prices.

Indeed from a plc view point, the recent Glanbia experience does little to reinforce investor confidence in the sector and adds pressure on all the food sector players in terms of maintaining performance, investor and banking ratings.

Many see the Glanbia experience as confirmation that co-ops and plc's do not make happy marriages.

The only exceptions to this rule are Kerry and IAWS* where the co-op holding stake is seen as an advantage in preventing the successful core company being taken over and at the same time giving management a free hand to continue delivering the goods.

*IAWS, Irish Agricultural Wholesale Society listed on stock exchange in May 1988.

The final outcome of Golden Vale Food Product's Co Ltd was that Golden Vale milk suppliers gave notice of significant milk transfers to Tipperary and Dairy Gold Co-operatives. Golden Vale plc (and its subsidiary GVFP) was taken over by Kerry Group in September 2001.

6.4 Comparison of Kerry Group, Glanbia and Golden Vale plc's

Despite the attempts by Glanbia and Golden Vale plc's to emulate Kerry Group, they are far from enjoying the same success. Although they have divided their business into 'consumer foods' and 'food ingredients' like Kerry Group, the reality is that they are still largely dependent on selling commodities. This is illustrated by comparing each division's contribution to the different company's turnover and operating profit.

Table 5: Turnover, Operating Profits and Operating Margins by Sector, 1998

	Kerry Group			Glanbia			Golden Vale		
	T/O	Op. Profit	Op. Margin	T/O	Op. Profit	Op. Margin	T/O	Op. Profit	Op. Margin
Consumer Foods	39%	27%	5.5%	44%	53%	5.8%	46%	87%	6.2%
Food Ingredients	58%	72%	9.7%	27%	31%	5.5%			
Commodity							37%	9%	0.1%
Meat				21%	6%	1.4%			
Agritrading	3%	1%	1.4%	8%	10%	4.8	7%	4%	2.5%
Total (Million Irish Pounds)	1,732.6	136.5		2,301	110.5		580	23.4	
Total Company			7.8%			4.8%			4%

Kerry Group's core business is food ingredients. Table 5 shows that 58% of Kerry Group's 1998 turnover is from 'food ingredients' and this contributes 73% of operating profit and a profit margin of 9.7%. In comparison 'food ingredients' is only 27% of Glanbia's turnover and it contributes 31% of operating profit and 5.5% profit margin. While Glanbia describes itself as operating in the food ingredients sector, the reported profit margin suggests that it is either comparatively inefficient (high debt or cost structures) or is not able to command the larger margins associated with truly added-value ingredients sales and marketing.

Comparing company operating margins also highlights the fact that Kerry Group is more removed from trading in primary produce. In 1998, Kerry Group achieved an operating margin of 7.8%, compared to Glanbia at 4.8% and Golden Vale at 3.9%. Kerry Group's operating margins are well ahead of

any other Irish dairy company and has a target of reaching a 10% Company operating margin by 2003. It is interesting to note that Dairygold Co-operative achieved an operating margin of 4.9%, and Carbery Milk Product's, also a co-operative, was 5.2%.

As previously mentioned, Kerry Management recognised the low profit margins of "5-6% at best" associated with trading in commodities in the late 1970's. They undertook a dramatic change in strategy to get into more profitable value adding activities. Kerry's results demonstrate the successful implementation of the strategy, particularly in food ingredients.

Despite a lot of talk and spin doctor hype from Glanbia and Golden Vale plc's, their division and company operating margins are typical of those associated with commodity sales. These results indicate that they have not been able to realise the operating margins achievable with well managed value adding diversification, or that they are still largely commodity traders despite the titles given to the divisions. The absence of any reference to commodity trading in Glanbia's Annual Report indicates that commodity sales are included in the results for the 'food ingredients' and 'consumer foods' divisions.

While Kerry Group has been very focused, disciplined and successful with its acquisitions, Glanbia and Goldenvale have made some very poor investment decisions. As one commentator said, "*since the success of Kerry Group, food ingredients and consumer foods are 'sexy' to investors.*" However, the success of acquisitions in these sectors as a rapid growth strategy (attractive to outside investors who are interested in profitability and growth) is not guaranteed. There are plenty of cases where acquisitions have been disposed of at significant loss against the purchase price. The cost of Glanbia's business disposals in 1999 was IR£66m, as referred to in the article "Exceptional Charges of £270M Post Merger" and "Glanbia at a Glance".

In June 1999, Sainsbury (one of the four powerful United Kingdom supermarket chains) announced that it intended to cancel its stg£100m liquid milk contract with Glanbia UK. In early July 1999 that business was sold to Express Dairies for IR£120m. The initial purchase price in 1997 was IR£135m. Under the circumstances the sale price was considered to be very good. Ironically one of the reasons it sold so well is that Glanbia UK's liquid milk operating margin had increased to 6% since the weakening of Milk Marque and a consequent 24% fall in milk prices. The improved margin to the liquid milk industry was significant compared to that of only 2 years earlier when the operating margin was 2% (1995/6) At that time dairy processors in the UK were competing for milk supply which maintained a healthy milk price. On this occasion Glanbia was fortunate to get the price

they did. Typically, selling a subsidiary from a position of weakness results in a marginal at best, deal for the seller.

A further risk for farmer shareholders is the bottom-line approach to subsidiaries taken by plc's. At Glanbia and Golden Vale there appears to be no commitment to building subsidiary profitability. Subsidiaries are only retained when they contribute to profits. In June 1999 Glanbia sold its beef subsidiary for £10.6m. It would like to sell the lamb and pig meat business but has been unable to find a buyer.

The dairy collection and processing facilities are one of the subsidiaries of the Irish plc's. If the dairy business is not 'profitable' for outside investors, or if plant up-grades or replacements cost too much, there is a very real risk that the plc will divest that subsidiary in order to fulfil outside investor expectations. This is far from ideal for milk producers who need a secure outlet for all of their milk.

Many reasons have been given for the other Irish plc's failure to meet Kerry Group's performance:

- Managerial ability. This was always mentioned as the first and most significant reason for the differences in plc performance.
- Over extended management in terms of the scope of the business and capability to profitably identify and manage acquisitions.
- 'Sweeteners' and guarantees offered to farmer shareholders in order to gain agreement for a proposal. The merger of Avonmore and Waterford included sweeteners that prevented the plc from immediately implementing the necessary strategies of rationalisation and paying less for milk.
- Paid too high a price for some of the acquisitions.
- Acquisition decisions not based on core competencies or a clearly defined strategy.
- Plc-investor-route an expensive source of capital. When the Irish co-operatives initially went the plc route in the mid to late 1980's, interest rates were around 13-15%. Now capital can be sourced at about 5%. Investors expect a return of at least 10% per year in share appreciation and dividend.

6.4.1 The Reality of Wealth Destruction

Kerry Group's impressive appreciation in share value, is often put forward as an incentive for the New Zealand dairy farmers to adopt this structure. The assumption being that the investment activities of the plc will enable farmers to diversify and add value to their businesses. Yet again this raises the point that Kerry Group's success was based on the implementation of a strategy that was specifically developed for that businesses unique attributes, core competencies and operating environment. Kerry Group performance is not easily replicated. The share value performance of the other Irish Plc's is well behind Kerry Groups as can be seen in the following table:

Table 6: Share Value Performance by Company

Plc	Year Floated	Float Share Price	Peak Price	Year of Peak Price	Current Price (1999)
Kerry Group	1986	£0.35	£11.11	1998	£9.70
Avonmore	1989	£0.80	£1.79	1996	
Waterford	1989	£0.80	£1.30	1993/94	
Glanbia	1997 merger	£3.56	£3.56	1997	£1.00
Golden Vale	1990	£0.75	£1.28	1994	£0.93

While Kerry Group shares have consistently appreciated at impressive rates, the other plc's shares have not even kept value with inflation. Avonmore and Waterford co-op members bought special issue shares at IR80pence in 1989. Ten years later they are only worth IR£1.00 – 20p appreciation in ten years. Providing these farmers with the opportunity to diversify their individual businesses in an investment company has been a dismal failure.

The share value at the time of the merger into Glanbia, an all time peak of £3.56, indicates the buy-in and speculation on savings and growth projections made at the time of the merger. Investor confidence in Glanbias's ability to deliver was very short lived. The performance of Golden Vale is equally unimpressive.

The co-op members have sold their co-operatives into investment firms. They have unlocked their wealth that was tied up in the co-op. For Kerry members, this wealth keeps appreciating. For Glanbia and Golden Vale members, the wealth is being destroyed, as the combined share appreciation and dividend is less than the cost of capital. They have reduced the farmer-

producer ownership and control over the company. They no longer supply a company whose “reason for being” is to serve their interests. They have transferred the opportunity to add value to their milk to investor shareholders. On balance, most of the people I talked to felt that the price dairy farmers have paid for the opportunity to add value to their businesses through an investment company was far too high.

The turnaround in opinion is stark. Mr Paddy O’Keeffe, a respected industry politician and commentator was initially a staunch advocate and supporter of the mixed co-operative/plc structure has changed his views. He is now looking to supply his milk to a co-operative if the plc’s reduce the price they are prepared to pay for milk. Mr O’Keeffe no longer sees stock market shares in Glanbia as a worthwhile investment. He sold his shares in 1998.

6.5 An Irish Perspective on the New Zealand Dairy Industry

Mr Hugh Friel, Deputy Managing Director and Financial Controller of Kerry Group made the following comments when he discussed the New Zealand dairy industry and appropriate structures:

- Ireland’s plc-route is the wrong structure for the New Zealand dairy industry. One hundred percent of our business is in milk and the conflict between milk price/supplying shareholders and profit/investors will occur. Kerry have come to the conclusion that a plc will not work if more than 20% of the company’s turnover is based on raw material sourced from supplying shareholders.
- A co-operative is the right structure for MergeCo. It will be the dominant company with little competition for raw milk in New Zealand. Milk is 100% of our raw material and a growing milk supply provides growth opportunities for MergeCo.
- Mr Friel supported the concept of MergeCo on the basis that critical mass is imperative for competitive advantage on the international dairy market.
- ‘Cost-leadership’ should remain a significant part of New Zealand’s strategy given our competitive advantage of low-cost milk production.
- It is “ridiculous” to have a marginal milk price. A marginal milk price will have a much impact as “shifting chairs on the Titanic”. Farmer unity is more important than minor cross-subsidisation.

- It is in a co-operatives interest to ensure it has a growing milk supply. Mr Friel saw huge opportunities associated with organic growth for New Zealand.
- New Zealand needs some form of return on share capital. The two key requirements for MergeCo's success are:
 1. Grow profits each year, continually.
 2. Grow dividend each year, continually.

Continuous growth in share value and dividend will encourage shareholder commitment and loyalty to MergeCo. Shareholders that leave the co-operative will lose the opportunity to share in the growth of profits and dividends.

- Have one board of directors and one management team. Invest all power with that board and management team. Any other representative council should be 'advisory' only.

6.6 Conclusions

1. The New Zealand dairy industry should not adopt the mixed c-op/plc structure. While this structure enables outside investor capital to be utilised to potentially add value to milk and members businesses, giving the plc direct control over the subsidiary co-operative is not in the dairy farmer members' best interest. There is no security that the milk co-operative subsidiary will be retained by the plc, and also there is a conflict of interest between milk intake strategy, 'profit' and milk price. Kerry Group has been a very successful development for Kerry farmers because of the unique attributes of that organisation. Attempts by the other Irish dairy plc's to emulate Kerry have not been successful. Each co-operative must apply a rigorous strategic planning process based on a sound understanding of its own company attributes and operating environment, in devising its own strategy. While elements of strategies may be similar a "me-to" approach is bound to fail. No two companies or co-operatives will be identical. Despite the interest of co-operatives worldwide in the "Irish Model", this structure has not been adopted outside Ireland.
2. It is not a co-operative's purpose to act as an investment company on behalf of shareholders. Any 'surplus' funds can be paid in the dividend to members and they can choose how and where to invest it.

3. 'Sweeteners' should never be used to gain farmer acceptance for mergers etc. Decisions to merge should be based on economic facts, and be motivated by the rationales of business continuity and maximising sustainable farmer returns. 'Sweeteners' debilitate a merged entity; they do not strengthen it.
4. "Hot" strategies like growth through acquisition and diversification into value-adding food ingredients and consumer products does not necessarily equate with profitability. Profitability is a function of many factors including business competence, not simply the sector of operation. The strategy of acquisitions is not a guaranteed recipe for business success.

Retaining farmer share holding as a co-operative block in any form of plc entity will maximise farmers' collective power and influence.

A dairy co-operative's purpose is not to act as an investment company on behalf of its members. It is to serve the common interests of its members, namely adding value to farmer members' milk and reducing their input costs. This should be stated in the co-operative's mission and direct the entire focus of the Board, the Management team and farmer shareholders.

This case study of the evolution, experiences and performances of the Irish mixed co-operative/plc structure illustrates the pitfalls and problems that arise for the supplying shareholders. The Irish dairy industry experience offers a real opportunity for the New Zealand dairy industry to learn vicariously rather than from potentially bitter, personal experience.

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Appendix I

Comments from Zwanenberg

Summary of Co-operative Characteristics and Comments

From “European Dairy Co-operatives Developing New Strategies, Adrie Zwanenberg Ph.D. Thesis 1997:

Member Commitment

“The committed response of members is the most valuable achievement of the co-operative. If the members feel that their co-operative is valuable to them, then they are prepared to finance it, they want to do business with it, they also take part in its management and they are prepared to accept the rules of the co-operative and to subordinate their own interest to that of the collective interests. It is essential that true commitment is not the result of propaganda and proselytizing, but must arise from the fact that the co-operative is the best alternative for the members. The co-operative must be aware of and capable of solving the current problems of its members.” Nilsson 1995, quoted in Zwanenberg’s Thesis.

Openness

“Members have to be kept very well informed to obtain their support for the strategy. If members are not well informed, they necessarily focus exclusively on the highest possible milk price. Eventually the co-operative is forced to use too great a part of the operating surplus in payout, leaving insufficient funds for longer term investment strategies.”

Member Participation

“Active participation by members is important as a means of ensuring that the co-operative continues to focus on meeting the members’ needs.”

Limited Interest on Capital

“[If the co-operative makes a distinction between milk price and return on capital,] capital to a co-operative should receive no more than the going market rate for such capital.”

“The rationale of limiting returns on capital in the co-operative is that the patrons should not benefit as investors...[or else] those in control of invested capital [could] drastically change the character of the co-operatives’ operations. It is

likely that the emphasis would then be on the protection of returns on investment rather than on [meeting the needs of supplying members]."

Benefit in Proportion to Use

"The concept of a variable dividend as a return on investment in proportion to any [surplus] made by the organisation has no place in a co-operative. Instead, any financial return or other benefit should relate to members' use of the co-operative and not to the amount of any capital they may have invested in it. This is a characteristic that sets co-operatives apart from other businesses."

"Closed" Milk Supply

"To become more market oriented [or] more attractive to external risk-bearing capital the priority order of objectives is first to maximise the long-term milk price and second guaranteed outlet for members' milk. Co-operative members forego their ability to increase value to their individual farm businesses by increasing milk output and rely on "growth" via a higher milk price. To realise the purpose of a high milk price, farmers accept the abandonment of the delivery right."

Non-member Milk

"It might be advisable to combat over-capacity by buying milk from non-members. However it is not advisable to build up processing capacity on the milk supplies from non-allied dairy farmers. If being a non-member is very profitable in terms of milk prices there will be great tension between members and non-members. Therefore, for the stability of the dairy co-operative: limit the percentage of non-members and offer a lower price to non-members."

International Membership

"Any extension of the number of members could be a threat to the interests of the existing members. On the other hand, the international scope of the co-operative could be expanded considerably if farmers abroad were allowed to become members." [The scope of the co-operative could be expanded without compromising its purpose.]

True Market Prices for Milk Do Not Exist

"Real market prices for milk do not exist. There is no open market where supply and demand determines the 'milk price'. Co-operatives act as price setters, but the 'milk price' paid to members includes a return on capital. Retained earnings for investment purposes also influence a co-operative's 'milk price'."

Co-operative is Not an “Investment” Company

"It is not advisable to take over companies for investment purposes. [In order to comply with the purpose of a dairy co-operative] the take over must improve the future outlet for members' milk or it must [add value directly to members' milk]. Investing members' capital is not the job of a co-operative.

The relation between the members milk activities and the other activities is a delicate one. The smaller the share of the 'core activities', the greater the danger that the core aims of the co-operative will be forgotten. It is advisable to ensure that the core activities take up a considerable part of the total company volume."

Predatory Pricing

Co-operatives are price setters for conventional companies. Conventional companies use price to attract or discourage milk supply. Predatory pricing is used strategically by conventional companies to draw milk supply and capital away from the co-operative. It is only when the co-operative is sufficiently weakened that plc's can practice opportunistic pricing policies.

Free Riders

The payout per kilogram of milksolids supplied paid by co-operatives includes members' return on (compulsory) capital investment in that co-operative. As co-operatives set the base milk price, 'free riders' can also get this return on investment without having to invest capital.

This short-term gain for the free riders results in the co-operative being weakened and all farmers receive a lower milk price in the medium and long term. While supplying milk to conventional companies will be advantageous to the 'free riders' in the short term, it is a case of 'short term gain, long-term pain'. In the medium and long term, the milk price paid to every dairy farmer will be depressed below what could have been earned.

Appendix II

The Kerry Way

When asking people about Kerry Group's success I was invariably told of Denis Brosnan's vision and leadership, and the top team he had in Hugh Friel and Denis Cregan. Their combined approach to formal strategic planning and their ability to infuse a shared clarity of purpose throughout the organisation were also top of the list.

Kerry Group has had the same top three executives since the Co-operatives formation in 1974. The lack of internal politics between and stability of these three men's competencies and complimentary skills must be a factor in Kerry Groups success.

Since returning home and reading "The Kerry Way" I found some of their management approach recorded:

"Strategic intent" is defined as having ambitions out of proportion to resources and capability.

"Strategic Management" is defined as how one gets an organisation from where it is now to where, after careful planning, it decides it wants to be in a period of years from now.

A focus on strategic planning that is "formal, critical, demanding and detailed". Strategic planning is ongoing, not a discrete, spasmodic activity that is addressed annually and put in the drawer until the following year. Strategic planning is not confined to top level executives, but involves participation from all levels of the organisation.

The strategic planning provides clarity of purpose that is promoted and diffused throughout the whole organisation.

The well-defined strategy gives very clear guidelines to all employees. For example acquisition scouts know exactly what sort of businesses Kerry Group aspire to be involved in. Kerry Group is very disciplined in negotiations to ensure they can reach their financial performance targets. They are also very clear on Kerry Group's current business activities and core competencies. For example, Kerry Group purchased Dalgety's food ingredients and flour milling business with facilities in Ireland, UK, Germany, Holland and Hungary in 1998. They immediately sold off the flour milling activities.

A belief in and commitment to "second best is not an option".

The overall plan is broken down to specific goals at every level of Kerry Group. Every goal has one person's name next to it. Kerry has developed a culture of personal responsibility in delivering specific results to achieve the Company's strategy.

Kerry Group managers all use the following Ten Simple Things:

1. Be clear on, and write down, your short and long-term goals. This focuses the mind.
2. Select a maximum of ten key issues that you and each of your colleagues must concentrate on in order to achieve the goals set. Goals and issues must be prioritised. Having 20 goals is the same as having none.
3. Know your core competencies. Focus on what you and the organisation do well, and work to eliminate your weaknesses.
4. Continually monitor progress.
5. Keep things simple.
6. Learn how to "eat the elephant".
7. Use the Loose Brick Theory. Look for under-defended territory and begin to build your business in a small way, staying below the response threshold of large and powerful competitors.
8. Would the organisation be more or less profitable without you?
9. Clearly understand and react quickly to your business environment. Sense the future.
10. Remember that change is continuous. An organisation must be responsive and flexible in its management of change.

Kerry Group have developed a recipe, "The Kerry Way", that sets the formula for all employees to use in their achievement of the strategic intent. However 'management' is as much about the people as it is about the processes. "The Kerry Way" reinforces the crucial role of any Board in appointing the right Chief Executive Officer for their business. Vision, leadership and continuity have delivered performance results for Kerry Group.

It will be interesting to see if the recently phrased "Fonterra Way" will enable Fonterra to define and implement its strategy with as much success as Kerry Group.