NUFFIELD SCHOLARSHIP REPORT

Of

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CAPITAL STRUCTURES OF LARGE CO-OPERATIVES

This study aims to look at how large co-operatives around the world are organising their capital structures to fund their growth strategies, successes and failures.

An issue particularly relevant for the New Zealand Dairy industry today as it looks towards the future.

TABLE OF CONTENTS

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INTRODUCTION

Many large co-operatives are grappling with the issue of how to fund their growth strategies without compromising the returns that they pay their farmer shareholders or put the co-operative at risk.

Fonterra also has to deal with the issue of how it funds its growth aspirations. The capital structure that was negotiated at its formation was at best a compromise through the negotiations and was only ever intended to be a short term option.

Other large co-operatives around the world who have similar growth strategies as Fonterra face similar issues of how to fund that growth within the co-operative. Fonterra has a clear objective to be a major player in the consolidation of the food industry that is in progress globally at the moment.

This strategy will require large investments in companies and businesses around the world and is in effect an investment strategy. An investment firstly in the long-term viability of New Zealand Dairy farming which is totally reliant on the international market place. And secondly an investment in businesses around the world so that we participate in the consolidation of the international market place and the value that will be created in the process will provide further security to allow us get our product to market and receive a fair market price.

It is also a hedge to ensure that we can better ride out the highs and lows of the commodity market as the returns from commodities and down stream businesses tend to be counter cyclical. The New Zealand dairy industry has over the years developed some core competencies in manufacture and this strategy is seen as a way of leveraging off those core competencies to add value to the business both in capital growth and as a way to enhance shareholder/owner/supplier returns. These groups are all the same in the co-operative.

So what are the issues

(a) The international marketplace is consolidating and our customers are looking for large suppliers who can supply their needs in many markets. This tends to mean that the suppliers who can meet those needs are likely to be preferred over those who can't.

(b) In the consolidation process value is created as those who are successful gain market share and achieve brand recognition.

(c) There is real value being created in the food industry but that value is more and more being created in the market place, with market share, brands and distribution, and not in the production end of the business (farms).

(d) A co-operative that is endeavouring to create value for it's shareholders will want to participate in that value creation on behalf of it's shareholders.

(e) This policy, if successful, will help secure markets and market share and therefore enhance the co-operatives long-term viability.

(f) This is an investment in the future but will require large capital investment that will sometimes take time to reap rewards.

(g) Farmer shareholders historically look to the milk price to measure their co-operative's performance. Milk price is often a poor measure of the success or otherwise of these investments, as these investments take time to reap rewards, but incur costs straight away with debt servicing etc. Also there may be a need to use some retained earnings as a means of raising capital.

(h) With this strategy comes risk, as there is no guarantee that it will be successful. If it fails then the co-operative has put its shareholders investment in the industry and their farms at risk as the shareholder is the lender of last resort. For a co-operative the stakes are always higher as the farmer shareholders are not passive investors but have their investments, their farms, their homes and their futures at stake.

(i) Some shareholders are concerned about this risk, particularly older shareholders who do not want their life's work put at risk for a reward that may take years to see the benefits from.

(j) If the strategy is successful, as we all hope it is, then it will be as much or more a value creation strategy as a way of improving the milk price. This is true even if there are reasonable dividends from the investments as those dividends will need to be reinvested in the business to contribute to the capital required to fund the strategy.

(k) If this is a value creation proposition, as well as a future security of markets proposition, then there will be an expectation that those shareholders who put up the capital, or who leveraged their farms to enable it to take place, should have the value created attributed back to them. The way to do this is to reflect the value created in the share price.

(l) This creates issues. Firstly if the investments are successful and the share price is high then shareholders could look to take their investment out of the co-operative through either exiting dairy farming and cashing up their shares, or exiting the co-operative, cashing up their investment, and supplying a competitor who will not have as high an entry cost.

(m) Secondly, New Zealand dairy farming has always prided itself in attracting high quality young people to the industry through the opportunities it created for these people to participate and eventually own their own farms. If the hurdle of entry to the co-operative is too high (and not necessarily supported by the milk price) the very people who are the future of the industry are then attracted to other competing companies.

If other companies are non-existent then maybe they will be discouraged from investing their future in the industry. Often this group has limited capital, are actively growing their business, and are therefore naturally attracted to options that allow them to keep their capital to grow their own business rather than invest with the co-op.

(n) Thirdly, one of the core competitive advantages that New Zealand dairy farmers have is their on farm, low cost of production. If in the future all dividends from value add activities is paid through the milk price (payout) and those dividends are a reasonable percentage of that payout, farmers will get the

wrong signal as to the value of additional milk and make business and investment decisions based on the signal they get from the co-operative.

This could potentially undermine NZ farmers ability to produce cost effective milk as they respond to the milk price, which includes a high amount of value add, and produce extra milk based on the payout and not based on the actual value of that additional milk.

(o) Should the co-op give their shareholders choices as to the level of investment they wish to participate in, or would this simply create tensions within the co-op as different shareholders have different agendas (also management). Also those who participated in the value creation process would still be leveraging off the whole co-op to fund growth.

(p) An alternative is to allow outside investors to participate. This can be done by making them a stakeholder of the co-operative which would require us to change the co-operative, or as a joint venture partner in the parts of the business that we are not prepared to fund ourselves, cannot raise the capital for or do not have the expertise to implement successfully.

(q) If the option of outside capital is used, within the co-operative, then we need to be aware of the consequences as there will most likely not be an option of returning to the status quo.

These are the issues that are the topic of this study. Other large co-operatives around the world have similar issues to deal with and it is my intention to find out what options they have chosen and why. Also to talk to them about any issues they foresee that may impact on their decisions.

As we grapple with these issues it is important that we collectively look inside ourselves and choose options based on who we are. For example what the co-operative means to us and what we want for it in the future as some of the options won't allow us to ever go back to the co-operative we grew up with. This is neither good nor bad as all organizations evolve and that is exactly what we must do. But it is important that we make these decisions with our eyes open, after a well informed debate, as the decisions will have wide ranging results and there will be no turning back.

I also intend to look at what makes a successful co-operative. Are there common traits that successful co-operatives have and are there common traits that failures have?

UNITED STATES

The United States produces 77.6 billion litres of milk annually (5.2 billion kg milk solids). The vast majority of growth in recent years has been in California, New Mexico, North/West Texas and Idaho/Wyoming. A lot of this growth has been in 1000+ cow feedlot operations.

There are 76,630 commercial dairy farms in the US (reducing by 4.5% annually). The average herd size is 120 cows (increasing by 6% annually). The average per cow production is 8700 litres or 585kg milk solids per cow (increasing by 2% per annum).

Since 1980 milk production has grown on average 1.3%.

United States Price Support System

The price support system is driven by two underlying principles,

- The public policy position is that food production is important enough to warrant government interaction.
- It is in the 'public interest' to have a safety net for those times when short-term low prices would damage the productive capability of the industry.

Due to the perishable nature of milk, small changes in supply or demand can cause large changes in price. Support price is set at US$9.90 cwt (NZ$6.83 kg milksolids)

The government maintains this price through the purchase of SMP, cheese and butter when market prices fall below target prices.

The US government can export limited amounts of these stock purchases under their WTO commitments, which they do under their 'Dairy Export Incentive Program' (DEIP).

- SMP up to 68,201 metric tons
- Cheese up to 3,030 metric tons
- Butter up to 21,097 metric tons

When the international price for Skim Milk Powder (SMP) reaches US$1820/ tonne the US are able to export SMP without export incentives.

Dairy farmers in the US supported and lobbied for the introduction of the 'Farm Bill'. The farm bill supports farmers by,

- Price support extension
- Counter cyclical payments
- Promotion Assessments for the promotion of milk consumption in the US.
- Continuation of DEIP.
- Continue price equalising program (PEP)
- Mandatory reporting

Johne's Research

- Dairy Indemnity Program

Dairy Farmers of America

Dairy Farmers of America (DFA) is the largest dairy co-operative in the world with a turnover of NZ$17.179 billion. Total assets of NZ$4.078 billion and a credit rating of BBB+.

They collect member's milk from 46 states and 15,133 farms, which is 28% of the US milk supply. Their total collection is 21.43 billion litres of milk (1.44 billion kg milksolids) per annum.

When DFA was formed in 1998, they had six Strategic Objectives,

- Enhance bargaining power in a deregulated environment.
- Achieve economies of scale.
- Market value added products.
- Provide service to customers and members.
- Capital generation.
- International influence.

DFA organise themselves into seven 'Area Councils'. These councils pay members in their areas proceeds collected in their area and when available from DFA investments. This means that each area could, and often does, have different milk prices that other areas.

These seven areas are,

1. **Mountain**, which include the states of Washington, Idaho, Oregon, Montana, Wyoming, Colorado, Utah and Nevada.
2. **Western**, which is the state of California.
3. **Southwest**, being Arizona, New Mexico and Texas.
4. **Central**, which includes the states of North Dakota, South Dakota, Nebraska, Kansas, Oklahoma, Minnesota, Iowa, the top half of Missouri, Wisconsin and Illinois.
5. **Northeast**, which include the states of Maine, New Hampshire, Vermont, Massachusetts, Connecticut, New York, Pennsylvania, New Jersey, Rhode Island, Maryland and Delaware.
6. **Mideast**, which includes the states of Michigan, Indiana, Ohio, Kentucky and West Virginia.
7. **Southeast**, which include parts of Missouri and Kentucky, Virginia, Arkansas, Tennessee, North and South Carolina, Louisiana, Mississippi, Alabama, Georgia, Carolina and Florida.

Their corporate board consists of 50 directors. The responsibilities of their corporate board include,

- Direct and control the business.
- Employ the President and CEO.

- Establish the financial structure.
- Determine the boundaries in the co-op
- Approve budgets and capital expenditure
- Set policies with regard to legislative issues
- Set policies of the co-op
- Employ auditors and legal council
- Establish the responsibilities of the Area Councils.

The Area Councils responsibilities include,

- Manage balancing plants
- Pay members subject to the proceeds collected within the Area Council, and when available, from value add activities
- Approve membership contracts
- Oversee local co-operative activities
- Assemble, transport, price and bill milk supplies to customers within the Area Council boundaries
- Operate the labs DFA investments.
- Structure local governance subject to overall bylaws.
- Hold member meetings.

-Capital Structure

Each member must invest US$1.75 cwt (NZ$1.20 kg milksolids) based on a two year rolling average annual milk production.

New suppliers or growing suppliers pay for their additional production over time

This base capital is paid back when a member stops supplying milk.

-Conclusion

DFA is clearly setting out on a strategy to add value to a higher percentage of their milk than they do at present. They do this by forming strategic alliances with organizations that have capabilities that are complimentary to theirs. They work hard at protecting and building on their size and influence.

They also use their size and influence to lobby Washington on behalf of their members and the US dairy Industry in general.

Dairylea Co-operative Inc

Dairylea is a co-operative situated in the North-east of the United States, with their collection coverage extending from Maine in the north, Ohio to the west and Maryland to the south.

Their mission is to be farmer driven and to seek to maximise net returns at the farm by preserving and enhancing milk markets and milk-marketing relationships. Also by providing services and programmes that create real economic value.

Dairylea through its shareholders, partners and independents contracted to it, manage 42% of the milk from within this region. One of their notable partnerships is that with Dairy Farmers of America (DFA). Dairylea have a strategic partnership with them whereby they manage all DFA's milk supply from this area. Their milk is managed

through a subsidiary company called 'Dairy Marketing Services' which manages milk from their own suppliers as well as those of their strategic partners and independents. The breakdown is,

25% Shareholders
25% Dairy Farmers of America Shareholders
25% Other Partner Co-operatives
25% Independent farmers

Through these partnerships Dairylea manage in excess of 5.8billion litres of milk per annum (350million kg milksolids) of which 43% is sold to processors for fresh milk sales. Milk is collected from over 7000 farms, which milk approx 545,000 cows.

Dairylea does not have their own processing facilities as they divested from processing through the eighties from 1980 to 1989. The reason that they divested from processing was that they believed that they didn't have any core competencies in manufacture and therefore were always competing with larger manufacturers who were also their customers. This arrangement also created some mistrust with their customers who were nervous of one of their main competitors also being their suppliers.

Dairylea have therefore concentrated on collective bargaining power to add value for their shareholders and on providing support services to their shareholders. Supplying services that their shareholders otherwise would not have had access to, or simply using their collective strength to get deals that their shareholders could not achieve individually.

Some of these services include

- **Insurance** -Life Insurance, Disability, Estate planning, Health and **Dental Insurance**, workers comp, Commercial Brokerage.
- **Financial Services**-Loan programs, Cattle leasing programs.
- **Livestock Marketing**-Auctions, Direct marketing
- **Farmers Realty**
- **Supply Services** -Buying Groups, Direct Purchasing, E-Commerce, Agri-Systems.
- **Agri Placement** -Sourcing Workers, Training, Continuing Education
- **Investment** -Pension Plans, Financial Advice, Non Farm Investments

There is a very small capital requirement from shareholders to fund this approach and Dairylea does not require an upfront payment from prospective shareholders to join the co-operative. Shareholders pay for their shareholding through retentions from dividends at a rate of 5c per 100cwt (NZ$0.03/kg milksolids)

Dairylea believe that the approach they have taken is the right one for them and have no plans to change and invest in their own manufacturing or marketing. They are very much focused on growing their shareholder base to capture a higher percentage of the milk from their region to give themselves more influence. Shareholders do not sign supply agreements with the co-operative. Dairylea rely on their ability to provide services that are of real value to their shareholders to keep them loyal to the co-op.

Dairylea's strategic partnership with Dairy Farmers of America (DFA) came about after they chose not to join when DFA was formed. The impression I got was that there was still a real willingness from DFA for them to merge but that Dairylea had no plans to do so.

Dairylea are very active politically and employ a lobbyist in Washington to present their case. Some of the things they lobby for include

- To reinstate the Dairy Compact throughout the North-eastern states.
- Seek to extend milk price support program
- Support supplemental manufactured products program
- Advocate funding of Dairy Export Incentive Program
- Seek limits on importation of milk protein concentrates

From my perspective as a New Zealander I felt some nervousness for them in the future, as they appear to be vulnerable to their customers continuing to use them as the preferred suppliers of milk and not develop relationships with farmers directly. To date they seem to have very good relationships with both their farmer shareholders and their customers.

Ocean Spray Cranberries

In 1959 Cranberries only came in three forms,

1. Cranberry in a plastic bag.
2. As canned sauce.
3. As canned jelly

Around 80% of all cranberries were consumed from Thanksgiving to Christmas and sold over a six-week period.

The USFDA decreed that chemicals used for fungicide control on Cranberries could cause cancer. This had the effect of reducing demand by 90%. (This claim was subsequently found to be false and the government paid out US$50 million in compensation).

Ocean Spray Cranberries decided that they would not allow themselves to be that vulnerable again. They increased their product range and produced a range of cranberry juices increasing their turnover to US$1.4 billion (NZ$3.04 billion).

Allocating supply rights to their members on an acreage basis controlled supply. These supply rights were traded between members. Grower co-operative members were paid US$55.00/100lb of cranberries (NZ$2.55 kg). Ocean Spray had an 85% share of the market.

In 1992 Ocean Spray's largest shareholder decided to exit the co-op. His shareholding in Ocean Spray was approx 10%.

He left to release his capital, but he also felt that Ocean Spray had become risk adverse as they became more successful and therefore were not doing as well as they should be.

He set up his own company called Northland and started producing commodities targeting and getting contracts to supply house brands.

Northland also started cherry picking customers from Ocean Spray. As they became more successful they started attracting suppliers away from Ocean Spray paying them US$80.00 100lb (NZ$3.70 kg) for their cranberries. They also began planting more acres of cranberries.

In response to losing suppliers Ocean Spray also started planting more acres of cranberries.

In 1995 Northland went to the share market and listed.

In 1997 Northland introduced a 100% juice drink. At this point they were flush with money from their successes to date. Their advertising stated that Ocean Spray only had between 19% and 29% juice in their drinks.

Ocean Spray was slow to react and took 12 months to put out a competing juice drink. When they did they did so under a different label as they didn't want their Ocean Spray label to be cannibalised. This strategy did not prove to be successful.

By 2000 there was a 30% oversupply of cranberries on the market and Ocean Spray could only pay their members US$10.25 100lb (NZ$0.47c kg) for their cranberries. Northland on the other hand, paid nothing to their suppliers and declared bankruptcy. Northland, were eventually bought out by an investment company. The break-even price for growing cranberries is US$35.00 100lb (NZ$1.62 kg).

In 2000-2001 there was a government directive to dump 30% of the cranberry harvest. The government also came to the party with a disaster relief fund.

In 2001 Ocean Spray paid their members US$25.00 100lb (NZ$1.16 kg) and in 2002 the expected price is US$35.00 100lb (NZ$1.62 kg), which is the breakeven price for the growers.

In 2000 Ocean Spray appointed Rob Hawthorn as their new CEO and set about reorganising the company. They had become a command and control co-operative, very centralised in their control structure. He changed that by decentralising operations

He cleaned out the top management and put in a new team. He found that there were 25 new products sitting on the shelf that could be implemented immediately.

He also changed the board. The Ocean Spray board consisted of 25 farmer directors and was very politicised, both in their functions and their election process. There are now 13 directors made up of 10 farmer members and 3 appointed.

They are now back on the road to recovery.
What are the Lessons?

In their early years they had so much success that the board thought management walked on water. This meant that management got whatever they asked for. The board became comfortable and lost control. Extravagance became the norm.

The high market share that Ocean Spray enjoyed meant that members/shareholders didn't have a choice who to supply as they had nowhere to go.

-Conclusion

I included this case in my report as I felt that there were some valuable messages here for us. We also have an environment where shareholders have nowhere to go if Fonterra does not deliver real value in returns on money invested and services offered before there is competition otherwise shareholders will take the opportunity to leave if an option presents itself. Or some of them will create an alternative option themselves.

Part of the message here also I feel is that Fonterra must never be allowed to develop a culture of arrogance where they lose site of the objectives of their shareholders.

Farmlands

Farmlands, has a turnover of US$11 billion (NZ$24 billion). They are the largest agricultural co-operative in the US and operate in 34 different states. Their have US$3 billion worth of assets (NZ$6.5 billion).

1300 Mid-Western Grain Co-operatives who are owned by farmers own them.

They started as a Petroleum/energy co-operative but expanded to include Fertilizer manufacture, Grain and feed manufacture and beef and swine slaughter. They are the fourth largest beef processor in the country and the sixth largest pork processor.

Farmlands have recently filed for bankruptcy. They extended themselves too far as they grew out of borrowings. They were more focused on growing than generating profits and so they simply bought their way to scale.

Management were focused on growing the business and did not read the business environment changes as they occurred.

- The fertilizer manufacture industry went offshore and Farmlands didn't see it coming and found themselves uncompetitive.
- They didn't see the changes happening in the grain industry and were left with a lot of obsolete elevators and assets.
- Energy prices are low and they have their assets in the wrong places.
- Only their beef and pork slaughtering operations remain profitable.

The general consensus is that management could not execute the strategy. They always paid for the best advice but did not implement their strategy. The value is created in the execution of the strategy and operational performance of the company and not by simply making the acquisition.

For all their size Farmlands could not 'fight the market' and ultimately failed.

Farmlands also became very centralised in their management.

EUROPEAN UNION

The European Union consists of fifteen member states at present being

Member State	Milk/Agricultural Production	Herd Sizes
• Belgium	15%	37
• Denmark	24%	63
• Germany	26%	33
• Greece	12%	14
• Spain	8%	20
• France	17%	35
• Ireland	35%	39
• Italy	12%	26
• Luxemburg	46%	39
• Netherlands	23%	45
• Austria	22%	13
• Portugal	15%	12
• Sweden	35%	33
• Finland	38%	16
• United Kingdom	23%	70
Average	***18%***	***30***

Milk production is the EU's most important primary agricultural activity contributing 18% of agricultural production value.

The EU introduced quotas in 1984 in response to the increase in production from European farmers who, when given price supports, increased production to take advantage of the guaranteed prices for milk.

The EU fixes two kinds of milk prices,

1. The guide price for milk containing 3.7% fat. This guide price will remain unchanged until 30th June 2005, i.e. E309.80/tonne (NZ$619.60). It will then be reduced by 17% during the three marketing years that follow.
2. The intervention prices for butter and for skim milk powder. Until 30th of June 2005, the price of skimmed milk powder (E2055/tonne) and of butter (E3282/tonne) will remain unchanged. Prices will then be reduced by 15% in three stages during the three following marketing years.

The price support system consists of several measures,

- Public intervention of butter and skimmed milk powder. National agencies purchase surplus products on behalf of the EU.
- Private storage aid for butter, skimmed milk powder and certain cheeses.
- Aid for butter used on the EU market by the confectionary industry, for direct consumption by non-profit making organizations and for direct consumption in the form of concentrated butter.

- Aid for the use of skim milk powder used for the manufacture of calk feed or casein.
- Aid for certain milk products consumed by children.

The EU exports around 13.6% of its milk production. Apart from some cheese, virtually all exports are subsidised.

The EU has a major though diminishing share of the world trade. In 1999 the EU share in butter was 19%, skim milk powder 20%, Whole milk powder 47% and cheese 37% (IDF).

At present imports into the EU represent about 8% of world trade and is equivalent to 2.4% of domestic milk output.

Most of the tariff positions for milk products are at specific rates and the present levels afford sufficient protection against imports. Up to now, most of the European imports enter into the framework of bilateral and GATT agreements (quotas).

Enlargement

There are 13 countries in the process of applying to join the EU.

Pre-negotiation criteria that applicant countries need to adhere to include

- Democracy and Human rights.
- A functioning economy.
- Adherence to political, economic and monitory union.
- Judicial and administrative structures.

Upon acceptance to the EU the applicant states must apply the 'acquis communautaire', which is the full body of EU legislation, 80,000 pages of text, half of which relates to agriculture.

The first seven of the applicant countries are expected to be eligible in 2004. They are Poland, Hungary, Estonia, Latvia, Slovakia, Czech Republic and Cyprus.

The others include Lithuania, Romania, Turkey, Slovenia, Bulgaria and Malta.

The countries wishing to join have much weaker economies than the existing 15 EU members; in fact the combined GDP of the 13 nations wishing to join is less than the Netherlands.

The GDP of the aspirant countries is 3,300 euro/head (NZ$6,600) and for the existing EU15 is 22,400 euro/head. (NZ$44,800)

All 13 applicants would increase EU GDP by only 4% but expenditure would increase by 50% under the existing conditions.

One of the key sticking points in the negotiations with the applicant states is the allocation of milk quotas and the level of support.

29,000,000 tonnes of milk quota have been allocated to the applicant states although the request was for 38,000,000 tonnes as that was the level of production in the Soviet era.

12,500,000 tonnes of this total will be allocated to Poland. How this national quota is allocated to individual farmers is still being developed as there are estimated to be approx 2,000,000 farmers in Poland with 1 cow or more.

Of these approx 800,000 send milk to a factory or have it processes in some form or another although the milk quality is generally not of a quality to meet EU standards.

This compares to a total of 650,000 dairy farmers in the existing 15 member states who produce 116,000,000 tonnes of milk.

There is also an expectation from the applicant states that their farmers will enjoy the same level of support enjoyed by the dairy farmers in the current EU15.

Although there is a recognition that in the longer-term perspective there can be no 'two tier' CAP, the proposal is that the new members payments will start at 25% of the present EU15, rising to 35% in 2006 and then to have the same level of support by 2013.

The total EU budget at present is E92 billion ($NZ184 billion) with E42 billion ($NZ84 billion) spent on agriculture. There is a strong will from the existing EU15 that this figure is held at that level and so there is a strong lobby developing to make payments to farmers for other 'services' provided other than producing food. Such as protecting, and being guardians of, the environment.

My feeling is that this change of focus is beneficial to exporting countries such as New Zealand as it takes the focus away from the production of subsidised food. The change of focus for the EU is simply another way of supporting their farmers with out breaking WTO rules, and most of the Europeans that I talked to were quite open about that, but should still lessen the amount of subsidised product finding its way onto the International market place. It is also hard to see how a country such as New Zealand can tell the Europeans that they can't pay their farmers to look after the environment that they farm in. From a New Zealand perspective though it is foreign to me that you should have to pay to in the first place as farmers generally see themselves as custodians of the environment. They generally take an intergenerational view and take pride in improving their farms.

There is very little indication though that access of products to the EU market, in the foreseeable future, will be any easier that at present.

IRELAND

Kerry Group

-Introduction

Kerry is headquartered in Tralee, County Kerry, Ireland. The Kerry group is now a diversified food ingredients and consumer foods company.

The company grew from a small dairy co-operative in the 1970's to a multinational company that has operations in Ireland, UK, USA, Europe, Canada, Mexico, Brazil, Argentina, Chile, New Zealand, Australia and Malaysia.

Sales of Irish based dairy products have declined to about 11% of total revenues. Kerry is now a world leader in food ingredients.

The Kerry Groups core strategy is to diversify and grow the business emphasizing differentiated food ingredients and consumer products.

-Background

Kerry Co-operative Creameries Ltd came into existence in 1972.

A brucellosis eradication program reduced their milk supply by 20% in the early 1970s. This helped the Kerry management and Board of Directors to focus on reducing their reliance on commodity dairy products and diversify into ingredients and value added products.

Kerry Co-operatives diversification program began in 1979-80 with the purchase of 19 Irish firms that sold branded food products.

In June 1986 when Kerry PLC was established, the co-operative sold their assets to the Kerry plc in exchange for 90 million plc shares. In July of the same year Kerry plc offered their shareholders and employees the opportunity to purchase Kerry plc shares for NZ$0.91 and an additional 10,350,000 shares were issued.

Kerry's first float was in October 1986 when 8,000,000 shares were offered to the market for NZ$1.35

Kerry plc today has 180,000,000 shares of which 64,000,000 are still owned by the co-operative (35%) and it is estimated that farmers own approximately another 13% directly.

The co-operatives shareholding has reduced from 100% in June 1986 to 35% today by Kerry plc issuing more shares to the market as a means of raising capital and also the co-operative at various times taking the option of giving their shareholders the option of trading co-op shares for plc shares. Thereby allowing them to access some of the value in those shares.

-Conclusions and Thoughts

Hugh Friel, the CEO of Kerry believes that Kerry had no choice but to go down the plc route as they simply didn't have the scale and resources to make the kind of investments that they have without access to outside capital. And it is the ability to pursue their strategy coupled with excellent management and strategic thinking that has allowed them to achieve what they have. They have created a world-class business with strong growth. When shares were first floated in 1986 they were introduced to the market at NZ$1.35 and today trade at NZ$11.41. Because of their support in those earlier years there is still a strong sense of commitment to the foundation shareholders. There is also still a strong sense of local identity to the Kerry region.

There is no doubt that Kerry has done an excellent job for their shareholders and farmer suppliers. The shareholder/farmer supplier enjoys three avenues of income.

- milk cheque, which is very competitive.
- dividends on their plc shares
- value appreciation of their plc shares

But if I look to the future farmer supplier of Kerry and ask myself what his or her income and prospects will be then I am not so sure that their future will be as bright. If in the next fifteen years or so the suppliers are not the same people who were there when the shares were issued then their only income will be the milk price. They will not even be the owners of the processing facilities, as the factories are owned by the plc. Will a dairy farmer in Kerry be able to survive and prosper in 2020 on only the milk price and if not what are their options?

It does beg the question as to whose responsibility it is to think of them.

One of the questions for us, as we head down the investment strategy that we have set ourselves is: If this is an investment strategy should we reflect the value created to those that took the risks or do we have a responsibility to the next group of shareholders that follow.

Dairygold Co-operative Society Ltd

Dairygold is the only one of the three large manufacturing companies in Ireland that still holds its processing and investment businesses in the co-operative. Dairygold collects and processes approximately 830 million litres of milk annually (60 million kg milk solids). This is around 20% of the national annual production.

Dairygold is also involved in other activities than those to do with milk collection and processing. They also

- Have animal feed sales of 310,000 tonnes
- Purchase 129,000 tonnes of grain from growers
- Total farm produce turnover of NZ$680 million
- Process 550,000 pigs and 125,000 cattle

Shareholding in Dairygold is one man one vote
Entry price is NZ$2600
Bonus shares are issued as a reflection of trading with the co-operative and not a reflection of milk supplied.

Dairygold sees this as a way of rewarding those that trade with them and contributing to the profits
Dairygold has 11000 shareholders

- 4000 are milk suppliers
- 4000 are dry shareholders or others
- 3000 are dead

Shareholders are not required to have their shares redeemed when they cease to supply the company, which is the reason that they have so many dry shareholders.
The company recognises that this is an area that they need to address, but which is now difficult as there are different groups with different interests.

Dairygold is also in the process of investing in the marketplace and is pursuing and undertaking joint ventures with others such as Firstmilk in the UK, which is also a co-operative.

Dairygold still sells about 50% of their production through the Irish Dairy Board.

Some interesting issues came out of my discussions with Dairygold executives

- Dairygold believe that rationalisation will mean that the three existing large processors, which are Kerry, Dairygold and Glanbia, will become two.
- Dairygold, which is the only co-operative among the three, would not have an issue with joining up with one of the other two and going down the plc route.
- Management is the only criteria for success. Good management needs the support of a competent board (skills), and there is a belief that the Irish system does not encourage that.
- Examples were quoted of board members supporting strategies at the board table and then campaigning against them at shareholder level, if that its shareholders do not support strategy.
- Kerry, as a model of success, is a reflection of good management and this is the difference between them and Glanbia.
- Acquisitions costs have a way of being bundled together with performance costs. Integration costs are included in the acquisition price and when they are not incurred they are simply added to performance. Hard for a board to pick up if the merger benefits are included in performance (Merger accounting).
- There is a belief that after 2008 Europe will be back as a growing player.
- National politics will dictate that any deregulation that occurs will be a step process. There will not be a wish to undo all the work that has gone into supply management to date. There is also a strong belief that the quotas will need to be in place as they integrate the East European countries into the EU.
- Quota has led to inefficiencies at all levels.

-Summary

My belief is that Ireland would be in a good position if trading conditions were liberalised in Europe, as their cost of production by European standards is low.

Protectionism has meant that the rationalisation that has and is happening in New Zealand has been a lot slower in Ireland.

Getting the most out of subsidies or handouts on offer has become an art form, which the best farmers learn well.

Dawn Meats

Dawn Meats is a privately owned meat processing and packaging company that has achieved spectacular growth in the last twenty tears.

In 1980 Dawn Meats consisted of one deboning plant with a throughput of 10,000 tonnes per annum with a turnover of NZ$5.2million.

At that time they started on an expansion program, which was funded by

- NZ$650,000 from the principles (owners)
- NZ$650,000 from borrowings
- NZ$650,000 from grants and new business incentives from the EU

Today they have

- 16 processing plants that process 1 million sheep and 500,000 cattle annually
- A turnover of NZ$1,560 million
- 50% of their turnover comes from retail packaging to supermarkets
- They participate in the value chain from purchasing stock from farmers through to consumer packaging for the supermarket.

One of the extraordinary things about Dawn meats is that they have achieved this spectacular growth from the initial contribution made by the principals in 1980. Dan Brown, who is the CEO and one of the two principals, says that they achieved this growth through good management, both operational and financial. Approximately 67% of their growth has been generic, which is all about adding value to the business through operational efficiencies, market positioning and building relationships with customers. The other 33% growth has come from acquisitions. But the company has always been strong enough through borrowings, cash flows and equity to fund these acquisitions without the need to look for outside capital.

Dawn Meats participates in an industry that generally operates on margins of 2-3%. Over the last 20 years they have purchased meat processing facilities from companies such as Kerry (Ireland), Glanbia (Ireland), Hazelwood (UK) and Sims (UK). These companies generally got out of the meat processing business as they found it a difficult industry to participate in.

On coming away from the meeting with the CEO, Dan Brown, and their CFO, Sean Breen, I was left with the strong belief that their success was contributable to four factors

1. Strong leadership.
2. Good understanding of the business.
3. Operational efficiencies
4. Clear strategy for growth

With these four strengths the business was able to support strategic investments when they were made and then access to capital was not a limiting factor.

In fact the comment was made to me that management always tends to be the most limiting factor to growth and not capital.

One of the things that also struck me was the value that was placed on the managers. There was a very flat management structure with site management having a lot of control over their own operations. Performance of the different sites was compared and shared regularly. Whenever senior management met at head office they sat around a

round table so that there was no hierarchy and all present were encouraged to contribute.

Dan Brown believes that the best managers are often home grown, as they understand the business and are already excelling within the company culture. The three things that he values most are calmness, common sense and numerical capacity.

THE NETHERLANDS

Introduction

The Netherlands is part of the EU and therefore falls under the European CAP (Common Agricultural Policy)

The Netherlands total production is 10.4 billion litres milk (822 million kg milksolids). This milk comes from a land that is 41,160 sq kilometres (approx 11% the size of New Zealand). The Netherlands has a population of 17 million people.

Quotas cannot be traded between countries, but there is no restriction within the Netherlands for farmers to trade quota.

They believe that their subsidies cost their taxpayers only NZ$0.04 cents a litre in direct costs.

It is next to impossible for a young person to become a dairy farmer unless they have a chance of inheriting a farm.

Farm prices range from NZ$90,000 to NZ$50,000 per hectare. Plus you need to buy quota which could cost another NZ$75,000 per hectare. (2.5 cows/hectare @8000 litres/cow x NZ$3.75 litre)

Farms can be handed down to sons or daughters for 60% of the market value without incurring gift duty. Quotas can be gifted, and often are, even though they are worth millions on the open market.

To purchase quota on the open market costs NZ$3.75 a litre, for milk that has a fat content of 4.4%. This is because the quota is based on fat produced and not necessarily litres.

To lease quota costs NZ$0.40c a litre on average for 4.4% fat milk. At times farmers pay up to NZ$0.55c if they are in danger of producing over their quota. If farmers produce over their quota then the penalty imposed on them by the European Commission is NZ$0.73c.

Average herd size is approx 50 cows or 380,000 litres. (30,000 kg milk solids).

Prices received for milk have on average decreased by 1% in the last 10 years. Costs are continuing to increase and so farmers are continuing to increase in size.

The environment is a big issue in the Netherlands with very stringent rules in place, with nitrogen and phosphate use closely monitored to ensure that the nutrients going into the farming operation equate those going out in milk or meat. All feed inputs that are introduced to the farm are also recorded.

The direct costs to run a farm equate to NZ$0.60 to NZ$0.65 cents per litre. If cost of own labour is included, then this cost increases to NZ$0.67 to NZ$0.72. If land or

opportunity cost is included then this cost increases by another NZ$0.04 cents. Prices received for milk at the moment are between NZ$0.65 to NZ$0.70 cents.

The cows spend approx 5.5 months inside through the winter months and the other 6.5 months outside through the day and then kept inside at night to feed concentrates and maize silage.

On average farmers feed 1,200 kg to 2,000 kg of concentrate to their cows. Of the balance the cows get 33% maize and the other 67% grass silage through the winter or grass through the summer months. Concentrates cost approx NZ$320 tonne.

Stocking rate is controlled because of the threat of pollution of ground water with a maximum of 2.5 cows to the hectare allowed.

Quota Management

This is an example of one of the ways that farmers here are trying to get maximum benefit from the quota system. I thought I would include it as it makes interesting reading.

The quota here is a quota on litres but has a fat component. That is, you can produce to your quota in litres at a fat percentage of 4.2 %. If the fat percent is higher or lower the amount of litres produced can be altered accordingly.

This particular farmer makes low fat cheese, and therefore, even though he uses 12.5 litres to make each kilo of cheese it only counts as 6.5litres as far as his quota goes. This cheese is sold for NZ$9.30.

The milk is separated to remove the surplus fat, which is then normally made into butter. But because butter is so high in fat each kilo of butter produced counts as 22 litres of quota used. The fat is therefore discarded into the effluent and not made into butter.

This farmer produces milk to his full quota allowable amount, but because he makes low fat cheese and discards the cream that would normally be made into butter he has 200,000 litres of production headroom. He leases out this quota for NZ$0.45c litre. This earns him a total of NZ$90,000 extra income.

It would be fair to say though that there is a high level of frustration with the restrictions that quotas impose and the environmental guidelines that are in place. There are a lot of Dutch farmers that are moving out of the Netherlands to farm. Mainly to the eastern block countries such as East Germany and Poland, but also to places such as Denmark and the USA.

Campina Dairy Co-operative

Campina is a co-operative dairy company based in the west and south of The Netherlands.

It has 7100 co-operative members in the Netherlands. These members produce 2,900 million litres milk. (230 million kg milksolids). This is 28% of the national total production.

Five years ago there were 8,900 members. Membership numbers has decreased as farmers are rationalising into larger operations.

Campina is in the process of merging with a German co-operative, Milchwerke Koln/Wuppertal that has 3200 co-operative member suppliers, with an output of 650 million litres (48 million kg milksolids).

Milchwerke Koln/Wuppertal was in financial trouble and approached Campina to form a strategic alliance. The discussions have now advanced to the stage where there will be a merger between the two co-operatives.

Campina is a strong co-operative and Milchwerke Koln/Wuppertal is not but there is to be no financial conditions attached to the merger.

On the surface it would appear that the benefits are one sided but Campina maintain that for them to grow they need to have a strong presence in Germany and to be seen as a German company as Germans are very nationalistic and tend to buy from German companies.

Germany is a market of 85 million people and is seen as offering great potential to Campina shareholders in general.

Milchwerke Koln/Wuppertal also brings to the merger brand recognition in the German market.

Campina process about 10% of all the milk in Germany.

Campina co-operative has a 100% owned subsidurary called Campina bv. All the assets of the co-operative are in Campina bv and this company undertakes all processing and marketing.

Campina has a turnover of NZ$7.8 billion. 32% of turnover is in the Netherlands, 40% is in Germany, with the balance of 28% turnover coming from the rest of the world but in particular Belgium, Poland and Russia.

Campina have a policy of getting more of their milk products into 'Value Add', which they define as 30% extra value compared to their other products. These value added products are mainly yoghurt, some cheeses and industrial products.

Interestingly liquid milk into the domestic market is not seen as 'value add' as there is little consumer loyalty to brands, and most consumers buy on price. The discounters and house brands have taken the margins out that business.

-Governance

There are 7500 farmer shareholder members supplying Campina. There are another 3000 members of Milchwerke Koln/Wuppertal in Germany and 80 members of De Verbroedering in Belgium. These two co-operatives have a strategic alliance with Campina.

The voting system is 1 vote per 100,000 litres supplied with a maximum of 5 votes per individual farmer. All farmers enjoy at least one vote regardless of quantity of milk supplied.

These farmer/members are organised into groups of 100 to 250, regionally based, that are called departments. There are 69 departments.

Each department is part of a larger geographical area called a district.

There are 10 districts in total with 9 districts in the Netherlands and one in Germany. After the merger with Milchwerke Koln/Wuppertal this ratio will change to seven in the Netherlands and 2 in Germany.

Each department elects members to a members' council on the basis of one seat per department plus one extra seat for every 20 million litres supplied. The members' council has 194 member councillors geographically elected.

The Members Council is seen as the highest managerial body in the co-operative and they elect the board members to the commercial board and co-operative board as well as the co-operative council, which has 30 members.

Each district elects one person to sit on the Board of the company.

The chairman is elected from this group and once elected to the position of chairman his/her position as a representative of their district is vacant and is filled by another from that district.

The board of governors consists of 14 people. The chairman, 10 members from the districts, and three independent commercial directors.

The board has a dual role

1. They are an advisory board to management regarding the strategic direction of the company and also monitoring performance. They meet once a month to fulfil this role.
2. The same group of people are the board of the co-operative although this is seen as a different role and the board meets separately once a month to discuss co-operative issues.

-Organisation

Campina is managed by a three man executive board which includes the CEO, and heads of Finance and Commercial Affairs.

The Department of Transport and Co-operative Affairs reports directly to the CEO as they believe that co-operative issues are important in a co-operative and the CEO needs to have first hand information of any issues that may arise.

The business is divided into five divisions

1. Cheese and Butter
2. Campina Netherlands
3. Campina Germany
4. Campina International
5. Industrial Foods and Ingredients (Includes pharmaceuticals and Cosmetics)

-Members Capital Contributions

A new member joining the co-operative needs to pay an entry price of 10 euros per 100 litres (NZ$2.60 kg milksolids).

An existing member that increases production only needs to pay NZ$1.30 kg milksolids for any increases.

Exiting members receive a nominal distribution at exit, presently 5.6 euros per 100 litres. (NZ$1.47 kg milksolids)

This nominal share price is adjusted each year at the discretion of the board.

-Payments to Shareholders

Each season Campina pays their shareholders a milk price (advance payments) and then at the end of the season they announce a dividend or performance profit.

Last season these were,

- A milk price of 28.96 euro cents per litre (NZ$7.62 kg milksolids)
- An end of season surplus of 3.97 euro cents per litre (NZ$1.04 kg milksolids)

Not all of this end of season profit is distributed to shareholders. Last season it was appropriated as,

- NZ$0.20c retained in the business for reinvestment
- NZ$0.15c Issued as subordinated bonds. These bonds have a 15-year life and are interest bearing. The interest paid is the official cash rate plus 1%
- NZ$0.69c is paid out as an end of season surplus

-Conclusion

Campina have a strong growth focus and see many growth opportunities for themselves firstly in Germany where they see a ready market of 85 million people, but also in the east European countries and Russia. This expansionist program will take large capital imputs that is being funded by generic growth and retentions from earnings.

At the moment they have no way of reflecting the value created back to their shareholders and only apportion a small part of the retained earnings to the exiting share price.

I was left with the strong feeling that if the milk prices drop as part of the reduced direct support for the milk price by the EU, and the continual need for more and more capital to fund this growth, that shareholders will question the wisdom of retaining their income to invest in a strategy that they themselves may never see any benefit from and have no access to the value created when they exit.

My understanding was that they were looking at these issues but had not yet decided on a future structure.

There is also a strong belief that the quota system in Europe will continue for the foreseeable future.

In New Zealand we always complain about the Import tariffs and quotas in Europe but I couldn't help thinking that if these were both lifted that the European milk price would come down to the world price and not the world price up to the European price. Initially at least there would be a large increase in milk produced in the EU, which would all need

to be sold, and would put enormous pressure on our markets. I feel that it is in our interests as well as those of the Europeans to ensure that the transition, if it comes, is done in an orderly manner.

Friesland Coberco

-Governance

There are approximately 13000 supplying shareholders although this number is reducing by 5% per annum as farms continue to rationalise into bigger units.

Shareholders votes are directly linked to milk supplied with no limit on numbers of votes per shareholder.

Friesland Coberco's shareholders are divided into 24 regions with each region contributing five councillors to the shareholders council making a total of 120 councillors.

The council elects the eight Co-operative board members. Generally from the council but not necessarily. These eight must all be supplying shareholders of the co-operative.

These eight co-operative board members are also all board members, of the advisory board, of the Limited Liability Company. These board members also select and appoint four independent commercial directors to the advisory board.

The advisory board is often quite pro-active in identifying and promoting shareholders who are perceived to be potential board members.

Under the advisory board is an executive board of the four senior executives, which includes the CEO.

The executive board effectively run the company and are responsible for the performance of the company and report to the advisory board.

The advisory board is responsible for setting strategy, targets for management, monitoring performance and reporting to shareholders and the shareholders council.

-Shareholding

Friesland Coberco Co-operative owns all the shares in Friesland Coberco Ltd and all supplying shareholders are owners of the co-operative in proportion to milk supplied although no shares are officially allocated.

When Friesland Coberco Ltd was established Friesland Coberco co-operative transferred all of its assets to Friesland Coberco Ltd in exchange for 5,840,362 shares. These are the 'A' shares in the company.

Friesland Coberco Ltd also offers 'B' shares to its supplying shareholders. They are called 'B' shares although no shares are issued. They are effectively Certificates. These certificates or 'B' shares have no voting rights.

These certificates are created as a means of raising capital from shareholders, who wish to invest further in the business, to help fund capital expansion.

Extra certificates can only be issued with the support of the shareholders council.

These certificates are only offered to existing shareholders or previous shareholders who are already holders of certificates.

Trading of these certificates is also restricted to existing shareholders or previous shareholders who are already holders of certificates.

A trading desk has been established and it is possible to buy or sell these certificates quarterly.

Potential buyers need to indicate how many certificates they wish to purchase and what price they are prepared to pay and potential sellers also need to indicate how many they have to sell and what price they are prepared to accept.

All the prices then offered and asked for are then compared and mapped onto an axis so that where the two lines meet is what the sale price is. So all potential sellers under that price are sold for more than they asked for up to the axis point and all purchasers offering more also purchase for the same price and so receive certificates for less that they were prepared to pay.

Purchasers who offer less that the axis price do not get the opportunity to purchase and sellers offering their certificates at too high a price do not get to sell.

When the certificates were first issued they were issued at E45 ($NZ 90.00). These certificates at the moment are trading at between E60 TO E70 ($NZ120.00 to $NZ140.00).

Holders of certificates can only sell them to supplying shareholders of previous shareholders. They cannot bequeath them to their children. If a holder of these certificates dies and bequeaths them to someone who is not a shareholder that person must on sell them within 12 months otherwise the company intervenes and sells them on their behalf.

There are presently 2,572,791 'B' shares in the company.

There is no obligation on the company to ever buy back these 'B' shares or certificates.

-Milk Payments

The milk price is calculated as an average of the expected milk price paid by five other co-operatives being Arla Foods, Campina, Nordmilch, Humana Milchunion and Belgemelk.

95% of this calculated milk price is then paid as an advance milk payment with the balance paid at the end of the season after the initial calculation is confirmed. If the actual milk price is higher or lower then the adjustment is made.

This is the price that Friesland Coberco Ltd has to pay to Friesland Coberco Co-operative for the milk.

Friesland Coberco Ltd is obligated to buy all the milk that is supplied by the co-operative members. The Co-operative though operates a closed-door policy and will not accept new suppliers into the co-operative.

The only exception being the acceptance of supply from suppliers moving into the region from another part of the Netherlands where they supplied another co-operative. Those prospective suppliers can then trade their shares in the other co-operative for shares in Friesland Coberco Co-op.

Any net income that Friesland Coberco Ltd generates, after paying the milk price, are profits. In 2001 these profits were E79.4 million (NZ$158.8 million).

60% of these profits are retained in the business to fund further growth and the other 40% are distributed to the A and B shareholders in proportion to the number of shares held.

- E16.9 million (NZ$33.8 million) to 'A' shares.
- E14.9 million (NZ$29.8 million) to 'B' shares.

As the A shares are held by the co-operative, they simply pass on this dividend to their farmers as a bonus on the milk price. The dividend on the 'B' shares is distributed to the holders of the certificates.

The shareholders council following a process that is fixed in statute decides the calculation of profit distribution between the A and B shares.

If a loss is incurred in Friesland Coberco Ltd then they could either choose to carry the loss over or pass the loss onto their A and B shareholders who are obliged to fund the loss.

Friesland Coberco would be prepared to take shareholders to court if any individuals refuse.

Using this system Friesland Coberco have always been able to generate the capital they have needed to fund their growth and see no immediate likelihood for that to change.

If they do find themselves in the position of not raising enough capital through this process their funding preferences would be

1. *Through their own balance sheet.*
2. *As retentions or some other form of member participation.*
3. *Joint Ventures.*
4. *Venture capital to kick-start new ventures.*
5. *Outside capital into the co-operative as a last resort.*

Rabobank

The Rabobank in the Netherlands is a co-operative bank owned by its member clients.

The Rabobank today has a very strong position in the Netherlands with 90% market share in agriculture, 40% market share in small and medium sized businesses, 25% in private home finance and 35% of the domestic savings market.

The first Rabobanks were established in the Netherlands in 1896 under the Raiffeisen principles and these included,

- Obligatory membership
- Unlimited liability of members
- No capital contribution of the members
- All profits were allocated to reserves
- No entitlement of profit distribution to individual members

By 1930 there were 1250 autonomous local Rabobanks and were important for the farmers as a credit bank and for the rural population as a savings bank. Today the number of local banks has diminished to 360 through mergers of local banks.

In the initial years when the fledging bank had no reserves the members signed an unlimited liability clause that effectively gave the bank access to security through their members. This clause was removed totally in 1998, as the bank now must rely on its own accumulated reserves for equity.

Each local Rabobank is an autonomous entity with the members appointing a local board of governors and then those board members appointing the manager.

The local branches own the head office and not the other way around. It was explained to me that they see the head office as their daughter and not their mother.

The head office of the Rabobank sets out lending guidelines for the local banks but because of the relationship these are hard to enforce and, although generally successful, there have been two failures in the last three years. The first 3 years ago for NZ$45 million and recently for NZ$225 million.

If a local branch incurs a loss, then all the local branches share loss, as they cross guarantee each other.

In a situation where a local branch has incurred losses the head office will,

- Cover 80% of the losses as long as conditions are agreed on
- Give technical support to reconstruct and 'soft' loans.
- 100% monitoring of loan approvals
- Will guarantee that the local bank makes a profit of at least NZ$120,000. This is to ensure that the local community does not become concerned that their money in the bank would be at risk.
- 3-year management control.

The Rabobank tries to attract membership by offering benefits that cannot be achieved if you simply bank there without becoming a member. They include:

- Control and influence
- Exclusive membership products
- Member programs

One of the exclusive membership products offered is the opportunity to purchase certificates that are offered exclusively to members. NZ$6 billion of interest bearing bonds were offered to members only. These bonds offer an interest rate of 1% above the state bonds and are keenly sort after with members trading them amongst themselves for NZ$53.40 even though their face value is NZ$50.00

Rabobank Netherlands has a branch that is Rabobank International. Rabobank international has aspirations to be a global player. This raises the issue of capital

requirements and funding. Rabobank Netherlands values their co-operative status and therefore is not open to a merger with a private bank.

But Rabobank Netherlands does not see Rabobank International as part of the co-operative and therefore are open to options of strategic alliances or mergers with Rabobank International.

The comment was made that,

'Rabobank International does not have the mission statement or structure of a co-operative'

DENMARK

Introduction

Denmark is a land of 48,000 sq kilometres situated in Scandinavia west of Sweden.

Denmark is also part of the European Union and therefore also works under the rules of the EU including the quota system.

Denmark was issued a quota of 4.4 billion litres.

They manage this quota and measure it at a national level. That is, individual farmers are not penalised for producing over quota unless the whole country produces over quota.

This is the same for the fat penalties. The total quota is calculated on a fat % of 4.2 but if individual farmers produce fat in excess of 4.2% they are not penalised unless the whole country produces milk in excess of 4.2% fat.

Denmark has 8500 dairy farmers with an average size herd of 70 cows and total annual production of 520000 litres. (38,000 kg milksolids)

There is a lot of rationalization in progress at the moment and the expectation is that there will only be half that many farmers in 8 to 10 years time with the farms being twice the size.

Ten years ago there were still 19,500 dairy farmers.

Danish dairy farming is intensive with the Danes housing their cattle for eight months and in the four summer months that they graze, they only graze grass through the day and are housed at night to ensure that they eat their required amounts of concentrates and silages. There is a growing trend to have a zero grazing policy.

Because of this intensity there is a requirement for large investments in buildings and infrastructure. An average farmer starting would need to invest per cow,

- NZ$17,500 in infrastructure. (Buildings, machinery, plant, silos)
- NZ$2700 to NZ$1600 for land. (Price dependent on location)
- NZ$3250 in stock (milking cow and her replacement)
- Total investment NZ$23,000 per cow

This compares to an average investment in New Zealand of $8200 approx per cow

The average replacement rate in Denmark is 35%. Animals leave the herd often simply to make way for fresh heifers, as the Danes believe that these young animals are genetically superior and more efficient.

Milk prices are slowly dropping by about 0.6% per annum.

There is a very poor relationship between profit and herd size until the herd size is in excess of 200 cows. The average taxable income is approx the same for all groups of farmers under 200 cows.

The average Danish dairy farmer has a taxable income of NZ$50,000.

Net income from dairy farming has remained static for the last 10 years.

The best 50% of Danish farmers have variable costs of NZ$3.95 kg milksolids.
The bottom 50% of Danish farmers have variable costs of NZ$8.10 kg milksolids.

There is a huge variation between the net income of Danish dairy farmers, with the bottom 20% having a net income of NZ$2000 and the top 20% a net income of NZ$115,000. Both of these figures are from herds of about 75 cows. Both of these groups of farmers employ about NZ$2,370,000 of assets in their farming operations.

Danish advisory organizations are trying hard to make Danish dairy farmers more business orientated and are introducing a number of initiatives including focused discussion groups based on the New Zealand model. I found it really interesting that a group of farmers that received such a high milk price, by New Zealand standards, were getting such poor returns for their endeavours and investment. There is also a strong belief that the trading environment will continue to be liberalised and milk prices will continue to drop accordingly. When Denmark first entered the EU and became part of the EU CAP policy their farmers benefited greatly from the higher prices and stable environment. But over time they have progressively whittled away this advantage by increasing their cost of production and capitalising their advantage into infrastructure and quota.

The belief that farmer's costs generally come up to meet his income is definitely true here.

-Quotas

In Denmark quotas are traded between farmers through an organised market twice a year, July and December.

Farmers wishing to sell quotas can indicate their selling price and farmers wishing to purchase quota can select the price they are prepared to pay.

The market then matches the buyers and sellers with all the buyers paying the same price even if they are prepared to pay more.

Those wishing to sell quota but are asking too high a price will not sell and will be forced to keep their quotas till the next such organised day.

Farmers can buy quota direct from another farmer through the purchase of land but in such a private agreement 50% of the quota attached to the land being purchased must go through the organised market.

Larger farmers have a restriction on the amount of quota that they can purchase but this restriction is expected to be lifted in the near future.

Quota is attached to the land in that dairy farmers must have one hectare of land for every 10,000 litres of quota that they own. These rules are for environmental concerns with effluent disposal.

Farmers pay about 3.5 to 4 Danish kroner for a litre quota. (NZ$1.00)

With quotas and subsidies there are always more restrictions. Some of the regulations in Denmark include

- A maximum stocking rate of 1.7 cow equivalents per hectare
- An annual account must be made of all feed and fertilizer imputs.
- Special approval must be obtained from the county for herds of more than 160 cows.

Arla Foods

Arla Foods is the result of a merger between MD Foods in Denmark and Arla in Sweden.

The two companies had common joint ventures since 1996 and fully merged on April 17th 2000.

Arla foods collects 92% of all the milk produced in Denmark and 65% of the milk produced in Sweden.

Arla Foods collects and processes 4 billion litres from 8000 member shareholders in Denmark and 2.1 billion litres from 7050 member shareholders in Sweden.

Arla Foods also collects and processes 900 million litres of milk in the UK and another 200 million litres from other parts of the world but these milk supplies are an arms length purchase from suppliers under contract.

Arla foods have an annual turnover of NZ$10 billion. Forty per cent of their turnover is in liquid milk, 27% in cheese, and 15% Ingredients, 12% butter and the remaining 6% in other products

Arla Foods pay a different price to its Danish and Swedish shareholders as each group of shareholders receives a share of the returns from their own domestic markets. The intention is to have a common milk price by October 2003.

Last season the milk prices were for the Danish farmers 2.60 Danish Kroner a litre. (NZ$9.56 kg milksolids). The payment to Swedish farmers was 3.08 Swedish Kroner a litre. (NZ$9.06 kg milksolids)

53% of Arla foods total turnover is from their home market of Denmark and Sweden. 16% from the UK, 15% from the rest of Europe, mainly Germany and only 15% from countries outside the EU.

They have a strategy to be strong in Europe, as they believe that gives them the best chance of success and price stability.

They aim to be only in selected profitable products and markets outside Europe.

They employ a total of 18600 people. 15200 of them in Sweden and Denmark.

-Group Objectives

Arla has an objective of paying a milk price of 5% above a weighted average of similar companies in Europe.

They also aim to grow their turnover by an average of 10% per year: 5% from generic growth, better market share, higher value products etc, and 5% from acquisitions.

-Governance

Their Board of Directors or 'Supervisory Board' as they call it, has 22 members - 18 farmer directors, nine from the ex Arla company and nine from the ex MD Foods company. Also four executive directors - two from each of the two merged companies but now employed by Arla foods.

There are 15,050 co-operative owners who are divided into 74 districts. From those districts are elected 140 members to sit on the 'Board of Representatives'.

Arla foods have maintained one-man one vote for the election of members to the Board of Representatives.

The board of representatives elects the members of the 'Supervisory Board'.

The true power lies with the Board of Representatives as they elect members to the Supervisory Board. They must also approve the strategic intent of the company and the annual budgets.

They see this as a strength as Arla believe that they would not want to pursue a strategy that did not have the support of their shareholders.

-Capital

Arla foods are funded 100% from retained earnings and leveraging.

They have a policy of keeping their balance sheet at 30% equity. All new acquisitions are also funded with 30% equity.

They see their co-operative as being the part of the business that processes and sells Danish and Swedish milk. Subsidiary companies that are operating outside their home market are owned 100% by Arla foods but are not seen as necessarily part of the co-operative.

There has not been a decision made yet as to how Arla foods will fund their growth strategy in the future but the issue is on the table at present. Farmers here have always been willing to fund the growth required to keep Arla foods ahead of the race even though they have no way of capturing the value created when they exit.

Arla foods hold back approx NZ$160 million from the milk payments for reinvestment in the co-operative.

The entry price for new shareholders wishing to join the co-operative is NZ$0.56c kg milksolids payable over three years.

When farmers exit the co-operative they are paid out NZ$0.93c kg milksolids

UNITED KINGDOM

Introduction

The United Kingdom is approximately the same size in area as New Zealand with a population of 60 million people.

When quotas were introduced in 1984 the UK was allocated 13,900,000,000 litres of quota milk. (1.02 billion kg milksolids)

This was 9% less than the country was producing at the time and so all farmers needed to cut back their production by 9%. This level of production is still in force today.

The UK is a net importer of dairy products as their domestic production is not sufficient to meet the requirements of their population.

Before 1994 all milk was sold through the Milk Marketing Board (MMB). The MMB had monopoly control of all the milk produced in Great Britain. The MMB was a trader of milk and on sold that milk to processing companies and distributed their returns to farmers as a milk price.

The MMB was also responsible for milk collection as well as Artificial Breeding Services, which included Sire Proving, consultancy and Research and Development.

One of the processing companies that bought milk was Dairy Crest; a farmer owned private company where shareholding was in relation to funds contributed rather than milk supplied.

My understanding is that farmers were generally happy with this arrangement but in the time of Margaret Thatcher this arrangement was seen as monopolistic and as such was frowned upon. The government of the day set out to break this monopolistic arrangement.

In 1994 the MMB set up Milk Marque, which would be a milk trader as the MMB was, but without the monopoly control. The intention was that 90% of the milk nationally would stay with Milk Marque.

In reality only 70% of the milk in England and Wales stayed with Milk Marque in '94 with this figure slipping to 60% by '97.

Many farmers didn't join with Milk Marque originally and some left later as they were attracted to higher prices being offered by private companies. They were often wooed for as little as one penny, or less, per gallon. Many of these companies who offered these premiums have not survived.

In the process of forming Milk Marque the industry agreed to divest itself of their processing, breeding, consultancy and Record Keeping interests.

- Dairy Crest, which was the MMB's processing arm was floated on the stock exchange and shares issued to farmer members. Those farmer members today own less that 50% of the shares.

- Genus Breeding was the AI and Sire proving company and was retained as a co-operative for its farmer users.
- Genus Consultancy as the industry's nationwide consultancy service was also distributed to its farmer users.
- National Milk Records (NMR) is the industry's database. It was also owned by the MMB before 1994 and is still a farmer owned co-operative.

In 2000, the government of the day, still considered that Milk Marque had too much control over the flow of milk and insisted that they be broken up to allow milk to be more competitively priced so that the British consumer could have access to cheaper milk and milk products.

The industry was given a directive to reduce its ability to influence the milk price and so on 1 April 2000 Milk Marque divided itself into three.

- Milk Marque North, which is Northern England, and now trades under the name of 'Zenith'.
- Milk Marque Central, which includes Wales as well as the English Midlands, is now trading as 'Axis'
- Milk Marque South, which is the south of England, trades as 'Milk Link'.

Axis has now joined up with 'Scottish Milk' and is now called 'First Milk'.

The three different groups cross over each other's boundaries to collect milk.

Quotas

The United Kingdom has a EU quota of 14 billion litres of milk. (1.3 billion kg milksolids).

This is less than they were producing before quotas were introduced, a sore point with English producers as their country is a net importer of dairy products.

Quotas are managed on a national basis, meaning that farmers are not penalised for producing over quota unless the whole country produces over quota.

Quotas are freely traded within the United Kingdom (which includes Northern Ireland). There are no restrictions to buy quota from one part of the country to another.

An agent generally facilitates the sales process, and takes a margin from the sale of quota.

Quota can sell for anything between 18 to 60 pence per litre ($NZ0.61 to $NZ2.03). At the moment it is trading for 21 pence per litre ($NZ0.71). Or NZ$9.86 kg milksolids.

Quota can also be leased and will trade for .7 to 3 pence per litre (NZ .24c to 10c).

I have not been able to get an accurate figure as to the cost of administering the quota system but the general belief is that there is a high cost involved with differing levels of officials involved.

When the quotas were initially allocated in 1994 they were issued to the farm, which was often the owner, but in some cases the tenant was entitled to some of the quota

allocation. There were no clear guidelines given as to whether the owner or the tenant was the recipient or how it should be calculated. In most cases the two parties have reached agreement but there are some still outstanding.

Farming Practices

As a generalisation the average British dairy farmer is struggling to make a living at the present prices they receive for milk. It appears that the average cost of production is 18 pence per litre and the average milk price is about 19 pence per litre.

This cost of production is generally before the cost of quota, before the cost of finance and before a return on capital employed in the business.

These farms were generally feeding between 2 to 2.5 tonnes of concentrate per cow. They are housing their cows for about six months and were using TMR rations.

But as is the case with all averages there are exceptions. I came across farmers who had a cost of production of 9 pence per litre. These were farmers who were adopting a low cost pasture based farming system with very low levels of concentrates.

I found the UK to be the least organised of all the countries I visited in the EU with the vast majority of farmers taking their milk price at the farm gate. There also seemed to be little motivation by the average farmer to do something about it. A comment I came up against often was that it was the government's fault that their industry was in the state it was in and it was the government's problem to sort it out.

After the industry was deregulated there were 46 different groups at one stage selling milk with nearly all of them selling milk to someone else to process or bottle.

The attitude of farmers in the UK was summed up well for me in Wales. In Welsh it is;
'Gelyn Cymro yw Cymro arall'
Which translates to 'A Welshman's enemy is another Welshman'.

The supermarkets in the UK are now in a very strong position and often take their quality assurance programs back to the farm gate. They are well organised and have built up a strong market position.

Another quote that was quoted to me was;
In France the consumer trusts the farmer.
In the USA the consumer trusts the processor.
In the UK the consumer trusts the supermarket.

UK farmers have a lot of work to do if they are to capture more of the value that is in their product and not let others capture all the value that is being created.

NEW ZEALAND

Tatua Dairy Co-operative

Tatua Dairy Co-operative is a small niche dairy company situated north east of Hamilton.

In the 2001/2002 season they produced 9.2 million kilos of milksolids from 138 supply numbers. None of their shareholders dairies are more than 12 kilometres from the factory.

96% of their products are exported through agencies off shore. Tatua have none of their own people living off shore but instead they travel to the market from New Zealand.

Their main products are Whey Protein Concentrates, Fresh Curd Caseinates, Hydrolysates and Specialised Proteins. They also have a small FMCG business that takes about 5% of their milk.

Tatua shareholders receive a payout that has a large component of value add. The payout they receive is significantly higher than the underlying value of the milk that they supplied. This is a reflection of the successful R&D and investment strategy that Tatua have pursued over the years.

The only way for shareholders to access these value add returns was through the payment for milk produced. Shareholders who had the ability to grow their milk supply through intensification or purchasing neighbouring properties were able to capture more of Tatua's returns through increased milk volumes, but shareholders who had limited growth opportunities for increasing their milksolids felt aggrieved that they never shared the same opportunity and were losing ground. This created a feeling of unfairness.

Tatua's answer was the introduction of 'Milk Supply Entitlements' (MSEs).

MSEs were issued to shareholders in proportion to milksolids supplied over the previous three years. There were 11.5 million MSEs allocated to shareholders although the annual production for Tatua was 8 million kg milksolids at the time. There is a requirement to hold one MSE for every kilo of milksolids produced to receive the Tatua payout in a 1 June to 31st May season.

The allocation process meant that there were approx 30% more MSEs allocated than were required by shareholders at the time. Shareholders who were growing their business could do so by up to 30% and still receive the Tatua payout.

Those shareholders who do not have the option of growing their milk supply have the option of,

- Keeping their surplus MSEs for the future
- Leasing their surplus MSEs to other shareholders who produce over their entitlements

- Selling their MSEs

The sale and purchase of MSEs take place between shareholders and is a negotiated or tendering process, which is often confidential between the parties, but the belief is that they are trading between $15 and $16 each.

The Tatua board must approve all MSE transactions.

If there is a leasing arrangement between two shareholders the amount of MSEs leased must be recorded on the 27th of May.

Tatua reserves the right not to accept milk from a shareholder who does not hold MSEs.

If a shareholder produces more milksolids than they hold MSEs then Tatua reserves the right not to collect the additional milk if there is not enough capacity in their plant.

If there is sufficient capacity and the additional milk is processed then it does not receive the Tatua returns but a commodity milk price.

Tatua will not issue co-operative shares in excess of MSEs held.

There are a few issues that Tatua are already aware of.

- MSEs do not deal with the issue of over supply at the peak as the MSEs are calculated on total milksolids supplied. This is a capacity issue.
- It is not practical to not collect all of the milk on offer on any given day.
- The issuing of MSEs has encouraged farmers to increase their production to utilise the MSEs that they hold. Their total production was 9.2 million kg milksolids last season compared to 8 million when the MSEs were allocated. This reaction was not expected.

My view is that the issuing of MSEs is an interesting evolution for Tatua and will drive some changes in behaviour for the shareholders as well as the company.

Shareholders will reflect the value of the company in the traded price for MSEs in the future and not their farms. Tatua supply farms should now trade at their underlying value.

As soon as some shareholders start supplying milksolids over their entitlements the value of the Tatua MSEs will become more transparent.

The board will need to make a decision when milk production exceeds capacity,

- *MSEs were allocated initially to reflect the total capacity of the company. If more capacity is required should they issue a corresponding increase in MSEs? MSEs are not required to fund the extra capacity, as the share standard would be sufficient to fund the additional capacity requirement.*

Tatua have now separated the value of their business from the underlying function of processing shareholders milk and have created a different driver in the business. As shareholders trade MSEs they will become increasingly interested in the returns that they generate.

Also in the future there will be shareholders who receive some of their returns as a commodity milk price and not the Tatua payout. The greater the diversity the greater the range of interests there will be.

CONCLUSIONS AND THOUGHTS

Control

All companies that are growing have the issue of where funds should come from to fund that growth, particularly if a high percentage of that growth comes from acquisitions. The topic is particularly relevant in a co-operative as co-operatives see themselves as intergenerational and are as much concerned with long-term survival and prosperity as with investment.

To understand this fixation with control and longevity that is common in co-operatives, one must understand why people and farmers in particular set up co-operatives in the first place.

Dairy farmers in particular produce a product that in its primary form has a very short shelf life. Cows produce milk everyday and the farmer cannot store it. This makes him/her very vulnerable to exploitation. Co-operatives are set up to give farmers collective bargaining power. They also give farmers the ability to collectively build processing facilities to turn milk into a more stable form such as milk powder, cheese, butter etc, which can be stored and negotiated with for a better price. This also gives farmers the added security and surety of having their milk collected.

There are good examples of dairy industries in countries that have not protected themselves by forming co-operatives and have paid a heavy price.

Or they may have formed co-operatives but through mismanagement and poor decisions have not been able to pay a competitive milk price, and consequently, have not been able to keep shareholders loyal to the co-operative.

There are also good examples of shareholders who do not see the value of a co-operative until it is too late.

I found the best examples of these attitudes in the UK. The old Milk Marketing Board did not use the monopoly they had to invest and secure the long-term viability of their members and so were not in good shape when they were disbanded.

I found many British farmers bargaining with their processors to secure an extra penny here and there for their milk, but collectively they are getting the lowest prices in Europe and have the least influence.

They have a huge hurdle to overcome if they are ever to change their position as all the space in manufacturing is now taken up by other companies who have now consolidated down to four main players. Those companies will not give up their positions easily.

There is a valuable lesson here for us in New Zealand as we head into a new environment.

Control in a co-operative gives farmers the assurance that the benefits will potentially accrue to them. To escape the limitations of funding from members and turning to non-members for that finance a co-operative potentially risks losing control of its own destiny.

A co-operative can find itself in the position of needing to raise capital outside the ability, or will, of their shareholders to finance. Or find themselves with the option of using someone else's expertise to add value to their business.

In that situation it is important to make sure that capital does not become part of the co-operative but in a joint venture with the co-operative so that the co-operative does not find itself in conflict with maximising its farmers milk price and returning a dividend to its non farmer shareholders.

Governance and Management

All successful companies and co-operatives I encountered had a common thread and that was that they had excellent management with a clear view of who they were as an organization and where they wanted to go.

Their structures were often different but always supported their strategies or if they were not then they had already recognised that fact and were working to address it. Many co-operatives were looking for suitable capital structures to fund future growth and reflect the value created back to those to whom it belonged.

The opinion was put to me, on more than one occasion, that the only criteria for success was management.

Undoubtedly the success of organizations such as Kerry and Dawn Meats came from management that had,

- Clear objectives
- An excellent understanding of the business
- High levels of integrity with their stakeholders
- Great vision
- Perseverance and tenacity

I came across a few interesting truths,

- You can't cut your way to prosperity, it takes capability and vision
- Beware of management that chase expansion for ego
- 70% of takeovers don't add value
- When you purchase businesses outside your experience there is a tendency to impose your experience on it

If excellent management is so important to the business what about governance?

- Directors are responsible for the appointment of the CEO and as such carry the ultimate responsibility for performance
- Excellent boards recognise excellence in management and are not threatened by it.

- Poor boards on the other hand are more comfortable with mediocrity and the status quo.
- Companies and co-op's with excellent boards and excellent management develop a mutual respect for each other and their respective roles. This respect is always earned and is not expected as a right.
- Good boards will also share their vision and aspirations with management and shareholders, ensuring that all stakeholders share that vision.

Co-operatives will outgrow their boards and management and it is the board's responsibility to recognise the skills needed in the boardroom and in their management/CEO.

- 'The right people attract capital'
- 'The wrong people destroy it'.
- Co-operatives generally do not allocate enough resources to people and too much to fixed assets.
- Co-operatives need to be economic vehicles that can benchmark themselves against public companies.

Capital

If a co-operative finds itself in a position where they are not able to raise the capital required to fund their growth aspirations it is important to first understand why.

I came across excellent businesses that have grown exponentially and have not found capital a constraint that couldn't be overcome. These businesses tended to have high generic growth. That is they generated a lot of their growth internally from being better than the competition at their core business. Often their total growth was up to 66% generic.

Businesses that were most constrained by capital tended to be those that were under performing.

It is possible for an efficient co-operative to be constrained by capital if their growth aspirations are outside their capabilities to finance. In this scenario it is important to be sure that the long-term price for that capital is acceptable. Often if a potential investor only brings money and nothing else, that finance can turn out to be the most expensive form of financing.

If a co-operative finds itself in a position where extra capital is required it is important to ensure that finance participates in any investment as a partner in a joint venture or similar and not as part of the core co-operative.

A potential joint venture partner brings the most value when they bring complimentary skills to the partnership and not just money.

Share Appreciation

In Fonterra there is now a fair value share. The fair value share is calculated on a discounted cash flow basis, which reflects the future earning capabilities of the co-

operative. This is a step forward from a nominal share as it ensures that value created inside the co-operative, from research and development and investment, will be captured by those shareholders who are part of the co-operative when it was created. This ensures that new milk does not dilute existing shareholders investment and also ensures that exiting shareholders can access the true value when they leave.

Performance and investment in the co-operative become a lot more transparent.

Assuming that the investments made are successful, and the share value appreciates over time, we do however create issues for us to contemplate.

New Zealand dairy farming has always prided itself on the quality and quantity of good keen young people entering the industry and eventually achieving farm ownership. In fact it is one of our core advantages, compared to dairying in other countries. Our average farmers are younger and more innovative. This has allowed us as a group to farm and prosper at world prices for dairy products. We have been able to keep the pathway to farm ownership open.

The fair value share in itself is not a threat to future farm ownership as farmers have historically capitalized the value of their industry into their land price. The fair value share simply makes this investment more transparent.

The issue lies in the future where Fonterra becomes more active in leveraging its balance sheet and capabilities to create businesses, and positions, in the market place. This strategy is as much about value creation and future earnings as increasing payout today.

Two issues come to the fore here.

- The first is that if the value created and reflected in the share price, is not supported by a corresponding lift in payout, Fonterra will be at risk of losing supply to alternative land use or a competitor as shareholders take the opportunity to capture the potential future earnings today by ceasing to supply milk to Fonterra and cashing up their shares.
- The second is that it will be hard to attract new milk to the co-operative from growing or new shareholders as the entry cost may become prohibitive. This would lead to new supply being attracted to competitors who do not have as high an entry cost. Or young farmers, discouraged from entering the dairy industry.

It is possible to manage an appreciating share standard by considering some possible alternative structures.

I did not find an exact solution that would necessarily suit Fonterra shareholders but there are a number that could be considered.

An option I came across was one offered by Friesland Coberco where their shareholders were given the option of holding certificates inside the co-operative where a lot of the value of the extra business was reflected.

Friesland Coberco used these certificates to raise capital as well as reflect value created back to their shareholders. These certificates were restricted to shareholders or ex-shareholders and traded internally. Any dividends generated or capital appreciation was issued and reflected through these certificates. They held no voting rights as ownership was still with supplying shareholders in proportion to milk supplied.

Another option is to create a separate investment vehicle, owned by the co-operative but where shareholding is not held in proportion to milk supply. This would create an option where shareholders could increase or decrease their capital invested, in investment activities undertaken by the co-operative, independent of their milk supply. Established farmers who did not wish to milk more cows still have a vehicle to increase their investment in their industry and young farmers who preferred to invest their money in their own businesses could choose to sell down their investments. This creates the opportunity for farmers growing their own business, whose capital is limited, to buy into this income stream over time.

Another option is for Fonterra to create a vehicle such as a derivative market that allows shareholders to sell the dividends attached to their shareholding to an investor. That person or company would then collect the dividends attached to that investment and any share appreciation. The ownership rights would stay with the shareholder.

This option would allow young sharemilkers or shareholders that believe they have better options for their capital, to still supply Fonterra but only receive the milk price. They would still be shareholders with all the ownership rights that are attached to their milk supply.

Profitable Milk

One other potential issue that will need to be considered as we move forward is the price signal that farmers receive for the production of their milk. If all future earnings are paid out through the payout, as we have done in the past, and earnings from investments increasingly become a larger portion of that payout, Fonterra potentially encourages milk production that is unprofitable. Farmers will respond to the actual payout and not to the underlying value of the milk produced.

It has been my experience that farmers are very good at responding to signals given to them. It is therefore extremely important that they get the right signals. Without a clear signal as to the true value of their milk New Zealand farmers would become less competitive over time.

From my observations it appears that the more a farmer is shielded from the real value of the milk he or she produces the less competitive he or she will become over time. When you look around the world the farmers with the highest levels of support tend to become the least competitive as those farmers firstly capitalise their support payments into their farm/business values, and secondly, their expenses generally come up to match their income making them over time, totally dependent on their support payments.

We do not have the option of receiving support payments and must always be vigilant to ensure that we stay competitive at producing milk for the parts of the world we have access to. Our ability to do so continues to underpin our success. As New Zealand dairy farmers we cannot allow ourselves to become uncompetitive.

The challenge is to give farmers a clear signal about the underlying value of the milk they produce and the returns they receive for the money they have invested in the co-operative.

These are some of the thoughts and views I developed in my travels. Hopefully they will be of some use to the industry as it ponders the pathway forward.