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New Zealand dairy industry - analysis of challenges,
opportunities & external factors impacting this
industry

New Zealand Dairy Industry 2001



**Analysis of Challenges, Opportunities &
External Factors Impacting this Industry.**

Kellogg's Rural leadership Program 2001

Executive Summary

The New Zealand Dairy Industry is a resourced based highly fragmented industry with the distinctive competency of low cost production of milk-to-milk product.

Fonterra co-operative has been created from a merger of three key players in the industry along with 14000 shareholders farmers, this company processes the primary resource of milk, manufacturing that resource into over 200 products and distributing to 120 countries.

This industry is often highly subsidised throughout the world by use of direct government subsidies to that of government protection by high barriers of entry and monopoly rent.

This report further explores the dairy industry's core competency's, its capabilities, resources, what current challenges are present and what may lie ahead, along with opportunities from an internal and external view.

The New Zealand dairy industry has been changing its business strategies constantly in the past 5 years. As a company Fonterra has focused specifically on capturing increasing market share by the use of alliances with commodity producers about the world, these activities will insulate this business from the appreciation of foreign exchange rates. Fonterra provides a product to a market that has ever-changing consumer trends hence it is constantly developing new products through research and development to satisfy consumer demands.

It is my conclusion that this business is vulnerable given its size, critical mass, location, consumer trends and reliance on exchange rates, regardless of its key core competencies.

Combining all these factors, the shareholders of the company will always have fluctuations to their farm gate return's from the product of milk. Fonterra's long term and short-term objective must be to minimise the risk of fluctuating and diminishing return's to its shareholders through the above mechanisms.

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INTRODUCTION

Any company that aspires to succeed in the increasingly tough business environment must first resolve a basic dilemma: success in the market place increasingly depends on simplified positioning strategies, yet many organisations do not know how to position themselves to create and sustain their competitive advantages.

In this report I will explore the strategic management of Fonterra (Fonterra Co-operative Group), New Zealand's largest, and the world's ninth largest, dairy company.

I will examine the resources, capabilities, and strategic positioning aspects to discover how Fonterra can build its competitive strengths. Special attention will be drawn to the complex set of core competencies based on the related resources and capabilities of this industry.

I will discuss the changes taking place in the business environment, analyse the effects of market externalities on the competitive environment of Fonterra, and explore how these externalities would affect the sources of competitive advantage. Further, I will examine possible opportunities and potential challenges which Fonterra faces. My strategic positioning analysis aims to discover how Fonterra could build and sustain its competitive advantages both within New Zealand and in the global arena.

This report will be broken into the following four parts:

- Part 1** New Zealand dairy industry and competitive conditions
- Part 2** A close look at Fonterra – its resources, capabilities and core competencies
- Part 3** The strategic positioning of Fonterra
- Part 4** Challenges and opportunities

ANALYSIS

Fonterra, a new co-operative established in 2001, accounts for 20% of New Zealand's exports and 7% of our GDP (Fulton, 2001, p.5). Fonterra operates in 120 countries and employs 20,000 staff, whilst supplying 30% of the dairy produce to the total world market.

Fonterra was created from a merger of three key players in the New Zealand dairy industry – the New Zealand Dairy Group, Kiwi Co-op. Dairies (New Zealand's two previous largest dairy companies) and the New Zealand Dairy Board (previously government controlled organisation responsible for international marketing and export of New Zealand dairy products).

Part 1 New Zealand Dairy Industry and Competitive Conditions

Before discussing the competitive advantages of Fonterra, I feel it is necessary to conduct a brief industry and competitive analysis. The following analysis will then help us understand the business in the context of a changing environment.

1. Dominant economic characteristics of the dairy industry environment.

The overall size and market growth rate – The dairy industry accounts for 20% of New Zealand's exports and 7% of our GDP. (Shareholders info.package). Demand for dairy products is forecast to grow by about 2% percent per annum. (www.fonterra). The fastest growth will be in Latin America, closely followed by, South Asia, the Middle East and North Africa.

- Technological changes – Fonterra has the world's leading milk processing technology
- The geographic boundaries of the market – New Zealand is supplying over 30% of the world's dairy products.
- The number and sizes of buyers and sellers – New Zealand dairy products are sold to 120 countries.
- The extent to which costs are affected by the economies of scale – New Zealand has the lowest costs in the world given the pastoral based feeding system.
- Distribution channels used to access buyers - Fonterra sells 80% of the products, while 20% are sold through individual exporters (Tatua, Westland)

Due to Fonterra holding an industry monopoly, the characteristics of the New Zealand dairy industry, as described above, are the same for the Co-operative.

2. *Competition analysis*

Having discussed the monopolistic characteristic of the New Zealand dairy industry, I will further assess its competition state, using Porters Model SWOT analysis.

1. Rivalry among competing sellers is weak due to the size and capacity of the business.
2. The threat of potential entry of new competitors is low due to the high set up costs. In addition the inertia or reluctance of suppliers to change as well as government support, virtually rules out any competition on the national scene.
3. Competition from substitutes is low. Although substitutes such as soft drinks are popular, they never can replace dairy products.
4. The bargaining power over buyers is low
5. The bargaining power over suppliers.

Suppliers need size to have leverage with such powerful customers (Fonterra.com). The need for economies of scale has led to consolidation of international dairy businesses through mergers and joint ventures worldwide.

The merging of the world's larger dairy companies appears to be a global trend and New Zealand follows closely what has recently occurred in Denmark. The Danish realised that their individual companies were too small to compete seriously in the international market and so combined with the larger Company Arla to become the seventh largest dairy company in the world.

Their managing director states "the trend will continue. If you do not wish to become a niche operation there is no other choice but to secure a place among the ten top international players" (fonterra.com). This is exactly what Fonterra has done.

3. *Driving forces*

The major driver of change is the export deregulation. This means companies will have to compete in a deregulated environment where they are at risk of a competitor entering the New Zealand market. Another driver is the unprecedented consolidation of consumer

activities among the global dairy market. This move leads to fewer and fewer, but bigger and bigger companies chasing milk supply and customers.

Part 2 A Close Look at Fonterra – Resources, Capabilities and Core Competencies

Every business must have its distinctive competencies in order to survive or prosper as competition becomes increasingly intense. The distinctive competencies of an organisation arise from two complementary sources: its **resources** and **capabilities** (Hill & Jones, 2000).

Resources

Resources can be divided into either tangible or intangible resources. **Tangible resources** include items such as land, building, plant, and equipment. **Intangible resources** include brand names, reputation, and marketing know-how (Hill & Jones, 2000). To give rise to a distinctive competency, a company's resources must be both unique and valuable.

People

A large number of staff and dairy farmers are the true assets of Fonterra. As John Roadley, chairman of the interim Global Dairy Company and a farmer said: "We have excellent people, in New Zealand and overseas, and they are our number one advantage" (Shareholder info. package). High quality staff secures high performance. The majority of supplying dairy farmers are also shareholders in the company. This, the sense of ownership tightly binds the business and the farmers.

Technology

Since 1994, Fonterra's predecessor, the New Zealand Dairy Group, has invested 7.5 million dollars on milk processing technology to enhance the inbound logistics of milk processing for plants in the Waikato region. The reduced transportation costs have led to greater economies of scale in production.

Financial

Fonterra starts trading with assets of NZ\$ 11 billion and NZ\$ 5 billion in shareholders' funds, with projected earnings of NZ\$14 billion annually.

Physical

There are 100 subsidiaries within the group and two major operating divisions; NZM and NZMP.

Global Research and Development

Fonterra undertakes research and development activities, both nationally and offshore, to meet the needs of the overall industry through organisations such as the NZ Dairy Research Institute. Through their considerable investment in research and development the Co-operative and its predecessors have been able to add value to its milk products - over 200 products are now manufactured and marketed internationally from New Zealand produced milk.

Good will Reputation
 High quality product
 Good customer service

Obviously, Fonterra's resources are unique and valuable, and these along with the market perception of New Zealand's natural environment and "green" image, enable it to exploit opportunities and neutralise threats.

▪ **Capabilities**

Capabilities refer to a company's skills at coordinating its resources and putting them to productive use (Hill & Jones, 2000). More generally, a company's capabilities are the product of its organisational structure and control systems. Fonterra has mastered these skills, and this claim is evidently supported by the company's annual quarterly reports, as a financial indicator of success.

▪ **Core Competencies**

Fonterra's resources and capabilities create three unique competencies

a) Low cost

Fonterra's advantage is to be able to produce milk at the lowest cost in the world given the pastoral based feeding system. Our dairy farmers are able to produce milk continuously

throughout the year, at the lower cost than Northern Hemisphere farmers, as we do not have the costs of housing cattle and providing large quantities of alternative feed throughout the winter months. Today we also have the added advantage of use of advanced technology to assist in lowering the costs associated with production - processing its product quickly and in huge volumes.

b) Global marketing

Fonterra' s expertise in exporting and global marketing is another major competitive advantage that allows it stands up well against its competitors.

c) Brand power

Brand name is a key element of the industry's success. New Zealand dairy products almost immediately spell out high quality to the rest of the world.

We believe Fonterra is able to respond more nimbly, since their restructure, to the changing market conditions and opportunities with its core competencies, which are valuable, unique, and very sustainable.

▪ **Competitive Advantage**

- (1) On the national market, the size and market dominance is one of Fonterra' s competitive advantages. The Dairy industry is where size matters so much. The only competing companies after the merger are two small niche players base on the West Coast and in Eastern Waikato. Although they will still have an opportunity to build their business with export deregulation, they don't have the capacity to serve globally, but will however operate in low volume high value Markets.
- (2) In the past, there has no secret to this industry competitive advantage. On the global market Fonterra' s competitive advantage is the lower price and high quality. that stems from New Zealand's environment and climate. This area of competitive advantage has not changed since New Zealand started exporting dairy products to Britain over 100 years ago.

(3) Global distribution and marketing

Fonterra is supplying 30% of all dairy product of the world. It has the largest share of the world market in dairy industry. Its products are sold through 120 countries.

Part 3 Strategic Positioning of Fonterra

Fonterra's position as a national market monopoly is based on its competitive advantages, and is established, in conjunction with government policy, to reduce competition, increase market efficiency and ensure the quality of our dairy products offshore.

- **Vertical Integration**

Fonterra is divided into three main divisions and is now responsible for the "entire 'cow to customer' value chain, including milk collection, manufacturing and logistics, and the manufacturing of ingredients" (Fulton, 2001, p. 5). New Zealand Milk (NZM) division is Fonterra's global consumer goods company.

- **Clusters**

The New Zealand Dairy industry is clustered in three main geographic regions of New Zealand – Waikato, Taranaki and Canterbury/Southland. This is due to the favourable environments for grass growth and milk production. This industry concentration means that the biggest milk processing plants and Fonterra management are centred on these areas – especially the Waikato. Other industry specialty and support services are also found in these areas. Examples of these in the Waikato include an internationally renown agriculture research station, one of the world's largest milk processing plants at Te Rapa and numerous local and international agricultural support industries e.g. Waikato milking systems, Gallagher's, stock firms, transport operators and fertiliser spreaders.

- **Fragmentation / Consolidation**

The shareholders of Fonterra, the 14000 supplying dairy farmers, are fragmented throughout these geographic cluster areas and other less concentrated areas of dairying including Northland and Canterbury. Fonterra has positioned itself to bring together these fragmented businesses and consolidate the processing of their raw product, milk, into manufactured value-added goods that both national and international consumers are demanding.

- **Alliances**

Global giants in the industry have already taken advantage of Fonterra's restructuring and joint ventures and alliances have been announced with Nestle for the American market and Melbourne based dairy companies for the Australian market. (Fonterra.com) These alliances, along with others made in South America and Europe, will enable Fonterra to insulate itself against the external pressures of fluctuating exchange rate's, consumer trends and intense competition.

Part 4 Challenges and Opportunities

- **Challenges**

Being such a new co-operative Fonterra faces a large number of challenges arising from both the internal and external pressures on the organisation.

Key internal challenges are managing the smooth transition to the new co-operative structure, the need to maintain shareholder satisfaction of their farm gate returns through economies of scale, marketing, and research and development, whilst ensuring that there is total transparency back to shareholders.

In the near term key external challenges for Fonterra are that they must consolidate and continue to expand its place in the global market, whilst at the same time manage their foreign exchange rate fixing.

Defending its competitive advantage as a low cost producer of dairy products is another of Fonterra's prime challenges. Countries such as Australia and Argentina, whose steady decreases in cost of production are eroding Fonterra's competitive advantage in the international market, are currently threatening this advantage.

The termination of the government regulatory package initiated to protect both Fonterra and New Zealand consumers and farmers, as Fonterra establishes itself on both the New Zealand and international markets, is a potential challenge. This will likely lead to export deregulation which allows new entrants into the industry for manufacturing and exporting of the raw product, and sale of liquid milk in New Zealand.

Other continuous challenges from the market that all large dairy companies, like Fonterra and its competitors, are facing include:

- Constant changes in consumer trends worldwide, and declining markets in basic commodities, creates the need to be nimble and change towards these trends, through value adding.
- Customers are consolidating on a global basis, thereby strengthening international purchasing power. The result of this are fewer and fewer, but bigger and bigger global competitors chasing powerful global retail companies, such as Wal-Mart.

To address the imbalance in market power, which resulted from customer consolidation, many international dairy companies have merged. In the past 5 years alone there have been a significant reduction of major players from 28 down to 14 through mechanisms such as alliances, takeovers and mergers.

- The world dairy markets are characterised by protection with high barriers to entry through export subsidies, import tariffs, and support price mechanisms, which effectively depress the world market price, not allowing a natural equilibrium to be formed. The situation may change with free trade pressures imposed by WTO. New Zealand has to free its own protected market in order to have access to a much bigger markets.

Fonterra will continue to expand offshore, as it has positioned itself to do so. However, as Fonterra challenges its top competitors in the global arena, it will have to continue to work hard to compete at home as well as away.

- **Opportunities**

The increasing globalisation of trade presents many opportunities for business and government alike. Considering that an estimated 60% of international trade is conducted between parts of the same organisation, differing rates of corporation tax offer an opportunity for multinational enterprises to effectively minimise their own taxes (Economist, 2000).

The opportunities that present themselves are really very straight forward given the size and scale of Fonterra. The opportunities lie in the following areas:

- Access to new markets throughout the world

Opportunities lie in Fonterra's ability to capture as much world market share as possible by the formation of alliances, mergers, and joint ventures with companies such as Nestle and Aria. Fonterra has opportunities to develop new products and take advantage of changing consumer trends by using research and development and co-operation from its alliance partners

- WTO removing restraining trade barriers into countries economies.

The lifting of trade barriers, such as China in 2005, will present huge opportunities for Fonterra; providing they can market correctly by understanding culture and methods of distribution within new countries, NAFTA looks like it will be removing trade barriers between Brazil / South America and the US, this will mean that Fonterra can market their product through America and into these economies as we have product in America already

- Identification of new markets about the world.

Fonterra has three options: a) continue with their same or similar markets, b) try new and different markets or c) use a combination of both. By sticking to their core competency of producing milk into commodity and value added products they are continuing in the same or similar markets that are low risk and close to their core competencies. Alternatively Fonterra can try new and different markets which would mean entering any type of market which would be extremely high risk and hard for Fonterra to sell to its shareholders.

- Research and development allowing new commodities to be developed adding value to the raw product milk.
- Alliances with other multi national food marketers and retailers about the world.
- Increase supply of raw product - milk

Currently 50 % of the New Zealand land available for pastoral dairy farming is milking cows so there is most certainly room to expand on supply of raw product.

CONCLUSION:

As you can see from the body of this report, Fonterra co-operative is a large multi-national company that processes the raw product of milk. Fonterra's competitive advantage is that it

has a low cost pastoral based system due to its climate and ability to grow grass all year round (specifically in the geographic cluster areas). This company operates in an environment that has high barriers of entry and artificial protection from the government by monopoly rent. It operates on economies of scale (selling millions or not at all) whilst keeping the processing costs to minimum, and vertically integrating its value chain from “cow to consumer” it is able to remain competitive in the world environment.

I have explored the resources and capabilities of Fonterra and have concluded that their strongest resources and capabilities lie in people, technology, goodwill, and providing a high quality product and customer service. Fonterra has used these areas and that of their core competency of ‘low cost production’ to be competitive within world markets.

The New Zealand dairy industry has been changing its business strategies constantly in the past 5 years. As a company Fonterra has focused specifically on capturing increasing market share by the use of alliances with commodity produces about the world. Fonterra has also realised that it provides products to a market that has ever-changing consumer trends hence it is constantly developing new products through research and development to satisfy consumer demands.

I have identified that the best opportunities are in capturing new market share and by adding value to products, preparing themselves to access new markets such as China and South America. However the real challenges for this company will be survival in a future environment devoid of government protection and a de-regulated industry allowing competitors to access its key core competencies. Fonterra must focus its energy on capturing market share to insulate itself from external impacts such as exchange rate fluctuations and consumer trends.

It is my summary that this business is vulnerable given its size, critical mass, location, reliance on exchange rates, and consumer trends, regardless of its key core competencies. Combining all these factors the shareholders of the company will always have fluctuations of their farm gate return’s and raw product.

Fonterra’ s long term and short-term objective must be to minimise the risk of diminishing and fluctuating return’s, to its shareholders, through many of the mechanisms discussed.

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