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Contributed Article

The following article looks at the up coming elections for the board of New Zealand dairy cooperative Fonterra.

Since its formation two years ago Fonterra has had a troubled life. The company, formed by the merger of 2 competing organisations, has been beset by controversy over its strategic direction, divisions in the Board and side issues such as the salary of the CEO.

The success of Fonterra is a major concern for Kiwis, as Fonterra, by some estimates, accounts for about 1/5 of New Zealand's total export income. It is also a major concern for the Australian Dairy sector as Fonterra now have significant shareholding in more than one Australian dairy company.

FONTERRA's DIRECTOR ELECTIONS

Tony Baldwin

Accountability in large companies tends to be fickle. Directors love to bask in good news glory. But when things turn sour, most dive for cover. Too often, only the chief executive is left standing in the line of fire.

In its first two years, Fonterra's performance has not been strong – certainly well below expectation. All eyes are now fixed on whether CEO, Craig Norgate, will keep his job.

But accountability rests with the board, not the CEO. The board sets goals and priorities for its CEO. If the CEO achieves those targets yet the company still performs poorly, the board is responsible, not the CEO. The board's strategic vision is likely to be weak.

If, on the other hand, the board sets the right goals but the CEO failed to achieve them, the CEO is responsible.

These questions are now sharply in-focus at Fonterra, NZ's largest company. Within six weeks, decisions will be made on its CEO and three directors.

During its first two years, Fonterra's governance and management has been weakened by three key problems. The company 'inherited' a divided board. The board 'inherited' its CEO. And the CEO 'inherited' two of his key senior managers.

Each original appointment was made in the grand political compromise between Kiwi, Dairy Group and the NZ Dairy Board when forming Fonterra.

Regrettably, Fonterra has lost nearly two years waiting for these weaknesses to be remedied.

An announcement is expected shortly on Fonterra's CEO.

Of equal importance will be shareholders' decision on whether to return three directors.

11 candidates are vying for the three board positions. An election campaign road-show starts in Whangarei on 7 May and ends a week later in Asburton. Voting packs and a video of each candidate are to be sent to all 14,000 Fonterra suppliers and votes will be cast under the system of single transferable voting (STV).

The key issue for voters is how to grow the business and increase profitability.

Fonterra has a comparatively weak balance sheet. Shareholders own just 26% of its assets. Growth cannot be funded from debt alone. More share capital will be required. Where will it come from?

This raises the thorny question of non-farmer investors – an issue confronting producer co-ops all around the world. Many different solutions have been developed. Many Fonterra farmers want to believe that the 2001 mega-merger relieved them of this problem.

Not so. In the international dairy foods business, Fonterra is neither large nor small. It is not a specialised boutique player (like Tatua). Nor is it a powerful foods maker (like Nestle, Kraft and Unilever).

Even in its area of traditional strength – basic dairy commodities (butter, cheese and powders) – Fonterra is not particularly efficient (as shown by the gap between the 'commodity milk price' and its 'actual milk payout').

In short, Fonterra is in 'no man's land'.

Key questions of aspiring directors are, what should Fonterra be and how will it get there? Will it confine itself to NZ milk or process more milk overseas? Will it diversify into non-dairy? If not, how will it lift its payout? The company's strategy released in August 2002 is simply too vague, too general and tries to be all things to all people.

Here are four related but more specific issues Fonterra must address.

Transparency: Fonterra *must* be more transparent and cut-down on hype. Fonterra's is better at spin than most political parties. As an example, the company trumpets its joint ventures in India, the UK, and USA and with Nestle as major break-throughs likely to boost returns to farmers significantly. Yet in its own calculation, the JVs represent just 3% of Fonterra's future value streams. But Fonterra still refuses to provide meaningful information to suppliers on the JVs' expected capital requirements and arrangements for sharing risks and rewards.

Pricing to farmers: This has been a fundamental problem in the industry for so many years. Put simply, Fonterra and its predecessor co-ops have not paid farmers the true economic value of their milk. True value varies across seasons, regions and volumes. The traditional payout also 'bundles' together returns from quite different activities. This has caused lots of distorted investment decisions. Unbundling farmers' payout and paying the true marginal value of raw milk is absolutely fundamental if Fonterra is to succeed. It also happens to be politically hard, as it will unravel lots of hidden cross-subsidies among farmers. However, if Fonterra fails to do it, its future is not promising.

Monitoring and share valuation: Every major decision by any company has an impact on its value. For large listed companies, these impacts are assessed on an on-going basis by lots of different institutions and reflected in the company's changing share price. By contrast, Fonterra's value is only assessed once a year by one firm following an administered process. In addition, Fonterra's share regime is confused by trying to achieve in one instrument four different objectives. Fonterra's 'fair value share' is designed to reduce the flow of new milk, reduce wealth transfers from existing to new suppliers, reduce barriers to suppliers switching from Fonterra to a competitor and provide an indication of Fonterra's expected future earnings. Clearly, some of these objectives conflict with each other. Others create new risks for Fonterra, like the impact of many suppliers redeeming their shares at the same time. In short, Fonterra's 'fair value share' achieves none of these objectives particularly well. It has also created complexities that few directors understand. Simpler, better mechanisms are available.

Leadership: In an industry created by the Government, it is not surprising that its leaders have tended to act like politicians. They get elected by reflecting what most suppliers think and like. Many say Fonterra's current chairman, Henry van der Heyden, is waiting to get a stronger majority of like-minded directors on his board before addressing the key issues outlined above. If this is true, it is a great shame. For too long, the industry has been held-back by weak leadership. Few directors have understood the real issues. Too few of those have had the courage to say and do what they know to be right. Suppliers want to be lead. But real leadership means reaching beyond the industry's age-old prejudices that seriously limit its potential.

Fonterra's director election process should not be a popularity contest. It should not reward candidates whose views square comfortably with the majority of suppliers. Rather, it should select people with strong strategic and analytical skills, an ability to think independently, an objective understanding of Fonterra's strengths and weaknesses, an ability to make hard decision and, most importantly, the strength to lead change with suppliers.

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