Fonterra's Competitors: Strategies and Performance

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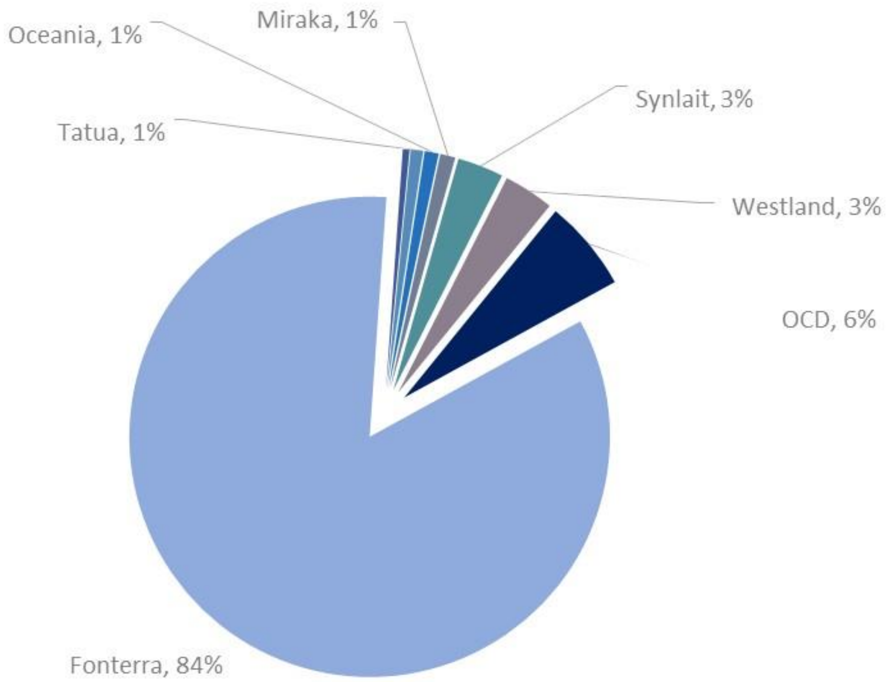
In 2002, when Fonterra was first set up, it processed 96% of the raw milk in New Zealand. The other 4% was processed by two much smaller co-operatives, Westland and Tatua, whose farmer-suppliers elected to stay outside the mega-co-op.

Now, fifteen years later, while Fonterra remains dominant in the sector, its share has gradually declined to around 84% of the milk produced in New Zealand. Tatua's and Westland's combined share has remained at around 4% and several new companies, including Open Country Dairy (OCD), Synlait, Miraka and Oceania are now operating. Together the new processors account for 12% of the market.

The six main competing dairy processors, while dwarfed by Fonterra, are sizeable businesses in their own right. Together they have total assets of above $2 billion and annual sales of around $2.3 billion. The estimated shares of the raw milk market in New Zealand of the companies are shown below.



In a recently published report (http://www.tdb.co.nz/wp-content/uploads/2016/05/TDB-Dairy-Companies-Review.pdf), TDB Advisory looked at the organisational form, strategy and financial performance of the dairy companies that compete with Fonterra. The paper finds the competing processors have adopted markedly different organisational forms and business strategies.

OCD, the biggest of the "new" processors with 6% market share, is an unlisted company that is 76% owned by Talley's and has around 60 other shareholders (making it a Takeovers Code company). OCD focuses on commodity products, largely wholemilk powder and bulk cheeses for export markets.

Tatua is a co-operative company owned by its 113 farmer suppliers. It operates at the other end of the value-add spectrum from OCD, producing high-value specialty ingredients such as hydrolysates and lactoferrin and consumer products like Tatua Crème Fraiche and Mascarpone.

Westland is another co-operative. It is in the process of trying to move up the value chain from base commodities into consumer products like yoghurt, UHT milk and butter. However, as discussed below, Westland's financial performance over the last three years indicates that the process isn't easy and isn't riskless.

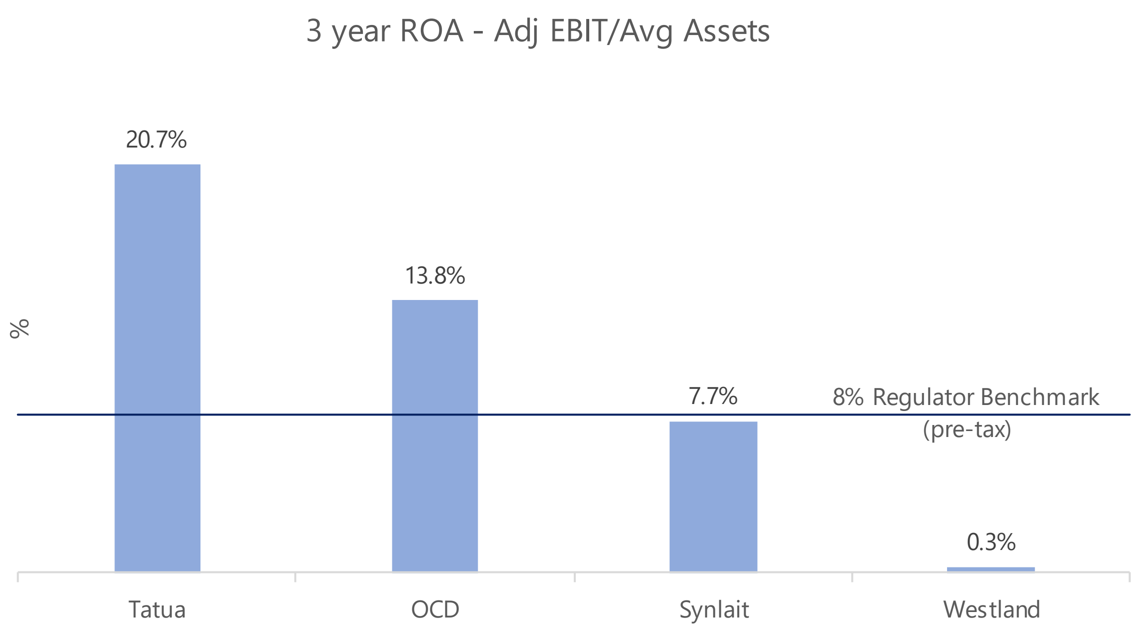
Synlait is a public company, with its shares listed on the NZX and ASX. Its strategy is based on moving from mainly producing commodity milk powder to producing high-value functional ingredients, infant formula, cream and UHT milk, and selling its products on a business-to-business basis.

Miraka is majority-owned by twenty nine Maori incorporations, the two largest being Wairarapa Moana and Tuaropaki, while Oceania is 100% owned by the Chinese-based Yili Industrial Group. Miraka, as a private company, is not required to disclose its financial data and while Oceania, as a foreign company, is required to disclose its financial data, it is still in its start-up phase and therefore its performance is not directly comparable with the other companies.

Comparing the financial performance of the four companies which disclose their financial statements is not straightforward. In particular, the two co-operatives bundle in with their payments for milk the investment returns to their farmer supplier-shareholders. To assess the co-operatives' returns on a basis comparable to the non-co-operatives, we have deducted the farmgate milk price from the co-operatives' payments to their farmer-shareholders.

The resulting adjusted average return on assets (ROA) for the four companies over the last three years is shown below.

Return on Assets (adjusted EBIT/average Total Assets), 2014-16



It is notable from the financial returns shown above that there is no strong link between organisational form and the financial performance of the company. The company with the highest return on assets, Tatua, is a co-operative and so is the company with the lowest return, Westland. In between are two standard common stock companies, OCD and Synlait.

In terms of business strategy, it is notable that the much-vaunted move out of commodities and up the "value chain" has not been necessary to achieve a strong risk-adjusted financial performance. While Tatua has performed best of the four companies, its high-value added strategy has required substantial investment in relatively risky businesses. In contrast, OCD's strategy of being a low-risk commodity processor has also proven successful, averaging almost a 14% return on assets over the last three years. OCD's business model is based on keeping its operating costs down and rewarding its farmers with a competitive commodity return.

Nor does moving-up the value chain guarantee financial success. As noted above, Westland has endeavoured to implement such a strategy but has achieved the lowest return on assets of the four companies, at an average return on assets of 0.3% p.a. over the last three years. Synlait's execution of its strategy has been more successful, with the company establishing strategic partnerships in advance of major capex decisions. Synlait's return has reflected its mid-risk strategy, at an average return of 7.7%.

While Fonterra is not covered in the TDB report, if Fonterra was to endeavour to follow a similar strategy to Tatua, even if it could, it would require an extra investment of almost $7 billion (to more than double its current investment in plant and equipment). This would equate to an additional investment of around $675,000 per farmer-shareholder, with no guarantee of success.

Investing in value-added branded products can work well but it is no panacea for inadequate returns and it doesn't guarantee success. Moving up the value chain requires substantial capital, takes investment in long-term trusted customer relationships, requires an on-going R&D pipeline generating new products and it involves considerable commercial risk. Our review of the dairy processors indicates that a variety of organisational forms and business strategies can be successful. The common ingredients are a focus on the customer, keeping costs down and ensuring the farmer-suppliers are well looked after.

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