Moving up the Value Chain - Myths and Reality

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A common refrain in New Zealand over more than sixty years has been that to achieve greater economic prosperity the country must move up the “value chain”. The notion is that to boost economic growth the country must focus less on producing basic commodities and more on manufacturing and supplying branded products. Instead of exporting logs or pulp, the country should make furniture and other timber products. Instead of exporting whole milk powder or bulk cheese, we should be producing “high-value” consumer products like organic yoghurt, specialty cheeses, neutraceuticals (foods that provide medicinal or health benefits) and pharmaceuticals.

This call to move up the value chain is superficially attractive: of course more value has to be created in New Zealand for the economy to prosper. But moving up the value chain and creating economic value are not necessarily the same thing.

Firstly, focusing on moving up the value chain misses the fact that the New Zealand economy can and has done very well by improving its productivity in producing basic commodities. On-farm productivity, for example, has increased far faster than off-farm productivity over recent decades. The increases in on-farm productivity reflect New Zealand farmers’ high and increasing efficiency at converting UV light, water and soil nutrients into a lamb rack or milk powder. That efficiency in turn reflects ongoing innovations from better collection and analysis of genetic databases, the development of new cultivars and endophytes, the use of online databases and software such as Overseer (that connects farmers to support sustainable farm businesses), and other innovations arising from our universities, research institutes and on the farm.

Similar innovations and sophisticated technological processes can be seen in our fishing, forestry, horticultural, and mining sectors. The processes New Zealand uses to produce and supply commodities are sophisticated technological tasks that add masses of value to our natural resources.

Looking ahead, as the use of drones, robotics and artificial intelligence becomes more widespread in our primary industries, the ways New Zealanders produce and export our so-called “commodities” will become even more sophisticated.

Secondly, the commodities New Zealand exports embody many services that are added to our agricultural and other primary exports. These services include legal, financial and IT services, transport, logistics and distribution, all of which appear as ‘primary exports” in our national statistics and which are overwhelmingly of New Zealand origin. These quirks of national accounts understate the country’s performance in the export of (embedded) services.

Further, it is not always the case that processed or packaged products are more valuable than a basic commodity. Seafood exporters, Sanfords and Sealords, discovered long ago that anything that is done to a live fish (from killing, to gutting and scaling, to filleting, to freezing, processing and canning it) reduces the price per kilogram that top restaurants in Tokyo and Shanghai are prepared to pay. The top dollar goes to live fish; the second top dollar to dead, but fresh, airfreighted fish. Fish filleting, canning and packaging operations can be profitable, but the best margins are often made in the basic commodity.

Moving up the “value chain” can add value, as companies like a2 Milk and Synlait have shown. a2 has created huge value for its shareholders through its branded product and channels to market. Likewise, Synlait, with its state-of-the-art processing facilities, dedicated microbiology laboratories and rigorous quality testing processes in the production of infant formula, has generated good returns. But at the other end of the “value chain”, Open Country Dairy, the country’s second largest processor of milk, has also consistently created economic value by focusing on the cost-efficient production and distribution of basic dairy commodities like wholemilk powder, milk proteins and block cheese.

In its annual dairy review, TDB Advisory estimates that all three companies – a2, Synlait and OCD - have created economic value over the last five years by achieving returns on investment that exceed their cost of capital.

Fonterra too has created value in its core businesses by being a highly efficient logistics manager and producer and supplier of ingredients into global supply channels. However, Fonterra’s attempts to move into consumer branded products have destroyed value. Westland Milk too lost considerable value with similar attempts to move up the value chain. Both Fonterra and Westland found moving up the value chain was costly, risky and capital intensive. Both companies moved up the cost chain but failed to grow their revenues faster than they were increasing costs. In these circumstances, while they were moving up the value chain, they were in fact destroying rather than creating value for their shareholders and for the economy.

The reality is economic value can be created anywhere on the so-called value chain. It can be created by being smart in the way New Zealand produces, collects and exports basic commodities. And it can be created by producing and supplying branded consumer products. Similarly, value can be destroyed regardless of where a company is on the value chain if a company has a poor strategy, fails to execute its strategy or has a structure that doesn’t fit well with its strategy.

It is all too common for promoters of value added to assume (or imply) that by adding value profits will improve. The reality though is that moving up the value chain can simply be a case of moving up the cost chain, without any increase in profits or value for the economy.

So where on the “value chain” does the greatest value lie? There is no simple answer to that question. The answer will be different for different industries, different regions and different products and will change over time. The real question is who is best placed to judge whether investing in producing and supplying at a particular point on the value chain is likely to create true economic value or not. Is it the entrepreneur with their own capital at risk? Or is it a politician, official or other commentator who thinks New Zealand is failing to capitalise on the many opportunities for added value that they believe exist, and that are just waiting to be taken up? If that were the case, the solution would lie in identifying the barriers that are precluding profit-seeking firms from overlooking valuable opportunities rather than trying to exhort them into moving up the value chain.

Adding value is hard, it is risky and it is not achieved automatically by moving up the so-called value chain. Nor is moving up the value chain necessary for New Zealand to prosper economically.

It is our productivity – producing more for a given quantity of resources – that ultimately determines our wages and living standards. And productivity improvements can occur anywhere on the value chain.

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