Comments on Fonterra strategy 2012

1. Introduction

In my letter to the Board dated 18 May 2009 I derived the following strategic focus for Fonterra:

Build upon our existing skills in cost-efficient milk operations, dairy food technologies and business-to-business marketing in order to become a globally leading dairy commodity and ingredients business.
Develop those existing consumer businesses that support this goal, that could defend that position and that are fitting for a New Zealand based company; Australia and New Zealand (ANZ) are the obvious examples.

Obviously, the strategy as outlined above leaves many questions unanswered.
In the same letter I identified four building blocks as a possible contribution to answering those questions.

Equity base and retention
I argued for a clear dividend and retention policy that makes very explicit which part of potential pay-out will be retained annually to secure the base for future pay-outs. That issue has been addressed head-on since then.

Flexibility in strategy
I drew attention to the view that strategy should not be cast in tablets of stone, but should consist of modules that can and often should be substituted to successfully survive in a rapidly changing market place.
I am sorry to say that I have not seen much movement in this area. It seems that the Board has not addressed the important and looming question of which part of the Consumer business has to be sacrificed to fund expansion in the Ingredients business.

Behind borders
I criticized the “Behind Borders” strategy for being opaque which is unfortunately a point that remains valid today. My main worry continues to be that the “Behind Borders” strategy has no boundaries, which will lead to a Fonterra ‘unleashed and unlimited. I sorely miss risk parameters by which to judge this strategy.

Supply chain
New Zealand’s strongly seasonal production and the requirements of continuous supply to major customers still seem to translate automatically in a strategy of investment in diverse physical supply chains across the world as the latest example in China is showing. I would be interested whether alternatives such as preferential trading or investment in logistics have been considered.

Those issues 3 years hence
My unease and worries regarding the above issues Consumer/Ingredients, Behind borders and Supply chain have not disappeared.
My comments on the recently presented snapshot of Fonterra’s strategy 2012, as written below, should be read against the background of the considerations above.

2. Fonterra’s 2012 strategy

There is much positive to be said about the strategic snapshot as recently presented by Theo. Building upon proven strengths, chasing growth in emerging markets, focusing on “healthy” product segments and streamlining the wide spread of present businesses are sound objectives and make perfect sense.

A few other important issues, though, seem not to be addressed. My purpose is to bring these issues forward without devaluing the positive aspects already highlighted.

In the Introduction I have drawn attention to the implicit dilemma of Consumer versus Ingredients business, the risks of the Behind Borders strategy and the available alternative solutions for the supply chain challenges.
Apart from the renewed dedication to the so called “integrated” model, these 3 issues have not been tackled yet.
I would, therefore, like to raise the 3 issues again and refer to my 2009 letter for background.

3. <u>New comments</u>

From my perspective four new questions are popping up:
- What is the major challenge that confronts Fonterra and will the chosen strategy deal with that challenge effectively?
- What is the guiding principle of our business and how does it make a difference?
- What exactly is our skill set and how do these skills relate to the strategy?
- Has the concept of the presented “cash flow house” been thoroughly thought through to its ultimate consequences?

What is the challenge?
The major challenge as derived from the 2012 strategy presentation seems to be how to catch a substantial part of the increase in trade-able global milk supply and stay relevant in the world of Dairy, based upon the size and composition of today’s operations.
I would, however, claim that Fonterra’s challenge is to create the highest possible value for New Zealand produced milk considering external developments, competitive forces and internal competencies.
Compared to non co-ops we will always be constrained. First by being obliged to use one input, milk, in whatever quantities supplied. Furthermore by a relative capital shortage with farmers being the only shareholders. That in itself is not a bad thing: it forces us to put even more focus on our strategy and make sharper choices.
To my regret, that is exactly what I find missing in the 2012 presentation: Sharp choices. Again, the Consumer/Ingredients dilemma comes to mind; and what to think of divesting parts of the business in order to fund new developments?

Guiding principle
I am still at loss what our guiding principle is.
It can hardly be our vision of becoming the natural source of dairy nutrition for everybody, everywhere, everyday. It is too broadly defined to be a guiding principle and I am glad that Theo already refined it in his presentation. It still is, though, an objective or a wish. It does not reveal how we are going to do our business and implement choices.
I find it equally difficult to see how it is different from competitors, either established or emerging ones.
So the question is: What makes us different from our competitors, is it a sustainable difference and how are we going to build on that difference. Access to quality milk, an integrated model and great people are not unique assets to us. Others have those as well.
Could it then be the globally distinctive customer base? If so, what is the underlying organizational competence, how did it develop and what support does it need?
If not the customer base, could it then be a combination of other skills? Do we know which skills and what makes the combination unique?
Important questions, it seems to me, which need analysis and answers before deciding on a strategy.

Skills and technology
Very little is said about our competences: skills, technology, embedded experience. They must, though, be at the heart of our competitive success.
I can think of our low cost attitude, global management of a complex manufacturing and supply chain, institutionalized trading skills in the global dairy market or a breakthrough technology such as the recent “quick” mozzarella process.

I would suspect that other skills are less developed compared to competition: e.g. international consumer marketing expertise and experience in managing independent subsidiaries at a distance.
I am just guessing as I am not familiar with the inner workings of Fonterra's organization. These are, however, critical and indispensable inputs for strategy formulation.

The cash flow house
Theo presented his 3-layered house as a basis for future strategy. I liked the structure as it showed that choices had been made on each unit's financial role and mission.
Two comments, though.

When the term cash cow was coined by the Boston Consulting Group more than 30 years ago, it was reserved for those businesses that enjoyed high or dominant market shares in mature markets. These were the preset conditions to raise cash for related "growth" businesses without weakening the foundation of the cash cow business itself.
Of the 5 businesses mentioned in the cash generating room of the Fonterra house, Europe, Middle East North Africa and USA do not satisfy the requirement of a dominant market share. So generating cash from these geographies will be difficult without destroying the source from which they stream. In my mind then, divestment seems the only logical alternative if cash needs to be generated.

A second comment relates to staff. Most people prefer to work in growing businesses with plenty of opportunity to advance. Being labelled cash cow or cash generator may not be very appealing. It takes a finely balanced approach to offer sufficient perspective for staff to develop and simultaneously milk the business for cash.
I just do not know whether Fonterra has those management skills available in Europe and the USA.

4. A final word

Theo was intent to emphasize that he would like to build upon the present and had not come to New Zealand to change Fonterra. I leave it to others to decide whether strategy 2012 represents change or not.
You will not be surprised that I would argue that some changes may be called for.

Let me conclude that I realize that a conceptual exercise as above tends to focus on what is supposedly wrong instead of right. I would, therefore, like to repeat that Fonterra has great value and is a company to be proud of. I would not have ventured to contribute to the strategic process if it were otherwise.

I would welcome any feedback or further discussion of the above, and would be happy to be of assistance where I can.

Jan Marten Kingma

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