Review of the Greater China tragedy: The prisoner's dilemma.
(all figures in NZD mln)

1. Inclusion of Ingredients

My original review of the Greater China tragedy, dated 2018-03-08, dealt with the Fonterra businesses in China but excluded the Ingredients business.
Board, Shareholders Council and management are stating that such approach is not correct for the following reasons.
Without the activities in farming, Beingmate and food service, the import of ingredients into China could well have been jeopardised in the past and may be negatively affected in the future.
In other words: all Fonterra activities in China have to be viewed as a whole and assessed as a linked activity.

I have therefore included the annual EBIT's of Fonterra's Ingredients business in my analysis.
Please view the attached spreadsheet.

On the basis of my estimate of the "China" share of Ingredients sales (ranging from 10% in 2008 to 25% in 2017) I have listed EBIT Ingredients for the ten years 2008-2017.
Total "Chinese" Ingredients EBIT over the period turn out to be 895 un-discounted.

I used the annual reports as my only source.
I amended the 2017 figure by adding the 38 farm sales loss as it had already been attributed to the other China activities in my previous spreadsheet.
It is interesting to note that the figures are not always consistent over the years. In 5 out of 10 years the annual Ingredients EBIT in the reported year is different from the last year's figure in the following year. E.g.: EBIT in 2012 was reported as 491 while that same figure was reduced to 477 in the 2013 report.
I have stuck with the reported figures as published in the actual year, although I suspect that the figures as reported in the following year are more correct. Had I used the "last year's" figures, total EBIT over the decade would have been 821 instead of the reported 895.

2. New conclusions

My original conclusion was that $2billion value had been lost as a result of investing in the so called "linked" activities (farming, SanLu, Beingmate and food service). In other words: if the total amount ($1.82billion) of all these investments would have been directed towards investing in "normally" performing businesses, that $2billion value would not have been lost.

I, therefore, logically deduce that we were willing to sacrifice $2billion in order to save the max $0.9billion created by our Ingredients business in China. That is not a very convincing story!
It definitely does not make sense to me.

I realise that it is a very rough and crude approach but I cannot do much more as detailed figures are not available; cash flow in particular.
The order of magnitude, though, indicates -to say the minimum- that the defensive investments to safeguard Ingredients imports into China have not delivered. And again, that is putting it mildly.

3. One step further

Most Board members and Councillors that I have talked to, are telling me that there is no alternative for the present China strategy. In view of the above, that is a very questionable statement; to say the least.

Let's be frank here.
If there does not appear to be an alternative for losing more than $1billion, we should not be in business in the first place. The bleeding needs to stop.
But, as we all know, there is always an alternative in life and usually more than one.

The real question is whether we are brave enough to consider the alternatives, modest enough to admit that we may have been wrong, strong enough to face the consequences of changing course.

One example may serve as an illustration:
Suppose that from 2008 onwards Fonterra would not have exported to China at all. The volumes involved (ranging from 10% of Fonterra's total Ingredients sales in 2008 to 25% in 2017) would, as a consequence, have been sold differently.
I can think of a mix of three options:

A. Selling to third parties, who in turn would export to China.
B. Finding new markets. Not easy but not impossible either.
C. Focussing more strongly on markets that we had already entered with good long term growth prospects such as Indonesia, Vietnam, Malaysia, Philippines.

As total global demand for dairy had not changed by Fonterra choosing not to export to China, our volumes would find their way to markets and definitely not end up in inventories. What probably would have changed is the gross margin on the products sub A.
Whether that would have reduced Ingredients EBIT considerably, I do not know. It depends upon cost structure, margin policy and a host of other factors that are entirely outside of my knowledge. I would guess, though, that we would be making some kind of profit as competitors out there are doing the same.

And remember: if, in a worst case scenario, EBIT on this 25% part of our Ingredients volumes had been zero, we would have had established a “new” $3billion value business. The result of $1,82billion invested wisely. And that would have more than adequately compensated for the absence of EBIT on the “China” Ingredients.

<u>4. Our prisoner's dilemma today</u>
We now know that we could have been much better off if we had not invested in China. The evidence above is more than sufficient proof for that.
Sadly enough, we cannot change the past.

So why not apologise for the mistakes, try to create some credibility with shareholders and change course?

As I see it, there is only one way out of this quagmire: a complete withdrawal from China.
Board and management will strongly argue against it, claiming that there still is considerable “real” value in China; represented by Farms, Food service, Beingmate and the Ingredients business. That is underlying their claim of around $4billion enterprise value in China, if I remember the figure correctly from the presentation at the shareholders meeting in Invercargill on 28 March.
On the basis of the evidence above, I would strongly contest that $4billion value figure. That can easily be done.
It is, however, not the point that I want to make here and now.

My point is that whatever value Board and management believe to have been created in our China business, it can only be unlocked by keeping all activities strongly interlinked. Board and management have made that sufficiently clear. Remove one brick from the structure and the whole building will collapse.

So, in order to protect the China Ingredients business (remember: average EBIT per annum of 89 over the decade and 156 over the last 3 years), we will have to keep investing considerable time, money, management and board effort into the linked businesses that are <u>not</u> performing; businesses that from my perspective will never be performing adequately with the possible exception of food service.

Essentially we are prisoners by choice. We are trapped.
Would we decide cleaning up and leaving the so called linked businesses that are not performing, we will jeopardise the only business that is consistently profitable: Ingredients.

And would we choose growing the only profitable business (Ingredients), we will have to maintain and further invest into businesses that we are not good at. Farming is not a core skill of Fonterra and we are “babies” in consumer marketing of baby-food internationally compared to the likes of Nestle. They will outgun and outcompete us at every corner.

So, what do brave and smart people do when they are trapped?
They try to escape at whatever cost. They risk life and property because the alternative is unacceptable. The alternative of staying trapped will slowly sap and exhaust all creative energy and survival instincts from mind and body.

The analogy with Fonterra is obvious.
By staying trapped in China, we will slowly but surely be infecting the healthy and vibrant bits of the organisation. Healthy and vibrant parts of which we fortunately have quite a few.
Such infection is the real “unacceptable”.
Escaping the Chinese trap is not unacceptable at all. It is the smartest decision that we can make under the circumstances.

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