It is time for a fundamental change

In this paper I will summarise my thoughts on Fonterra’s strategy as they have developed over the years. The recent developments such as the change of guard at the top, the unjustified gagging of former director Leonie Guiney, the Beingmate and Danone disasters, the scrapping of the final dividend and the disappointing 2018 annual results have given it more urgency that I originally thought.
I shall start by addressing the essence of a co-op, followed by my view on strategic management. I shall then touch upon the various strategies that Fonterra pursued over the last decade. Finally I will address the actions that should be taken to implement the results of my views in order to turn around the business and make it future proof again.

<u>1. Co-ops: their raison d’être.</u>
In its most simple form, a co-operative is a means for fragmented suppliers of a commodity product to avoid being screwed over by more powerful customers. In the case of Fonterra: dairy farmers supplying milk.
Its main function is insuring members from being passive “takers” of a milk price established by others. To be farmers, not peasants as former Fonterra director Jim van der Poel was not tired of repeating. And rightly so.

As a consequence, wealth creation within the farm gate is a joint effort of the co-operative and the individual farmer.
The co-operative tries to maximise milk revenue for every farmer, paying each farmer the same price per unit of milk.
The farmer runs his dairy operation in such a way that his margin is the highest possible. By optimising scale, costs, productivity and stock sales, each farmer chooses his or her own preferred system leading to the lowest possible unit cost and resulting in the highest profit.

As a result every strategic question for a co-op, in our case Fonterra, starts and ends with the assessment whether the market position and livelihood of farmers will be better insured.
Starting from scratch, the first question could be whether Fonterra should invest in milk collection equipment such as vats and milk tankers or in factories for processing milk.
Let’ s run a simple thought experiment.
Suppose that all of present Fonterra factories (20-30?) in New Zealand would be owned by different and independent processors, operating under “normal”

anti-monopoly legislation. And suppose that Fonterra would contract all milk on behalf of farmers to these processors. Would that deliver a different milk price from today?
It is not my intention to demonstrate that it does or does not. I do not have access to all the relevant information. I want to make it very clear, though, that every investment decision that Fonterra wants to make, should be assessed against that basic “insurance” principle. And running so called “crazy or out of the box” thought experiments will often deliver surprising insights.
So why not run a few of these thought experiments? Why not consider options as Fonterra owning 50% of its factories and 3rd parties the other half? Why not conceptually pursue the option of Fonterra being a commodity business only? Why not try to imagine that Fonterra does not have a Chinese business at all and 25% of its annual milk production needs to go to different players?

I have proposed these thoughts to Board members at various occasions but never got a positive response. Neither were they willing to tell me what other options had been considered before a specific strategic decision was made. That leads me to the tentative conclusion that thinking in strategic options is not widely practised within Fonterra.
I am wondering whether that attitude explains the serious strategic troubles that we have today.

2. The absence of strategic thinking at Fonterra

I studied strategic management as part of my Economics degree, practised it during my corporate career (BP: British Petroleum) and taught the subject at university. It does not make me an expert, I do not claim ignorance either. The book that represents the best in the field to me is Richard Rumelt’s Good Strategy/Bad Strategy. His message is that strategy is really just careful thinking about business problems. Straight and simple.
And the kernel of strategy is the in-depth diagnosis of a situation, the choice of a proper guiding principle and the design of coherent action.

Applying that to Fonterra, I often wonder whether in-depth analysis of business problems are regularly practised. Take China as an example. It looks as if we have unconsciously stumbled into a situation where more than 25% of our milk now ends up in China and are now frightened by the consequences. As if it just happened without us intentionally steering it?

As to the guiding principle, I do not have a clue. We are trading commodities, selling ingredients and marketing fast moving consumer goods in many, vastly different and highly competitive markets. We act as if we have all the required skills in abundance. We also seem to think that this wide variety of skills can peacefully co-exist together in one and the same organisation. I have argued before (view my website www.kingma.co.nz) that such reasoning cannot stand serious scrutiny. Cultural differences do not allow it.

And what about coherent actions?
If the diagnosis proves to be superficially executed or plainly wrong and the guiding policy is entirely lacking, coherent action can only be a shot in the dark. The present China situation is a case in point. We are trapped in China as I argued in a previous paper. Coherent actions based upon in-depth analysis and strictly bound by a proven and suitable guiding principle would never have brought us to that point.

I, therefore, conclude that the guiding policy for Fonterra must be the development and strengthening of an "insurance" structure for individual farmers. Every investment must pass that hurdle. A hurdle that measures the degree of strengthening of the "insurance" effect of the investment against the costs of the investment.
And that is a separate hurdle from other more conventional ones such as ROI (return on investment), DCF (discounted cash flow) or Pay-back time.

3. History of a decade of Fonterra's so called strategies

Fonterra has revisited its strategy a few times over the last decade. I will summarise the tweaks and changes below. One constant is the objective of penetrating overseas consumer markets. Another is the acquisition of overseas milk pools to compensate for the seasonal milk production in New Zealand.

The "Behind Borders" strategy (2008) was partially, if not completely, based upon the assumption that Kiwi's know at least as much about –say– Chinese business customs and consumers as either their Chinese competitors or well established international food companies such as Nestle or Danone. Under that assumption, therefore, Fonterra is equal to these bigger players in assessing risks. And Fonterra has behaved and is still behaving as if it is an equal.
If it weren't for amply available evidence to the contrary, the Sanlu and Beingmate experience have proved the fallacy of that assumption more than

adequately. And I am pretty sure that we can include Brazil in that category soon.
Fonterra should have taken that lesson aboard as early as 2008. As a result, the obvious strategy would have been investing in Ingredients and only maintain "defensive" consumer positions in its home markets New Zealand and Australia.

The 2009-2011 business plan was presented as a jig-saw puzzle and built upon the Behind Borders strategy. It did introduce the concept of "ring fencing" international consumer operations but did not specify it further. Nor did it introduce parameters by which to judge and decide which countries would be inside or outside that ring.
Globalisation of the supply chain again featured prominently. Acquiring additional milk pools to off set seasonal NZ supply was stated as an important objective in order to maintain the 35% market share of globally traded milk. The option of acquiring additional milk through contracts instead of direct investment in foreign milk pools was never mentioned. It confirms my earlier observation that thinking in terms of strategic options does not appear to be practised frequently.

The 2012 strategy announced by the new CEO Theo Spierings can be summarised as building upon proven strengths, chasing growth in emerging markets, focusing on "healthy" product segments and streamlining the wide spread of present businesses. These are sound objectives and make perfect sense. It also leaves much to be desired.
The major challenge is still defined as staying relevant (the 35% market share) in the arena of globally traded milk. To which was added soon after that Fonterra aims at a $35bn turnover and feeding 2bn consumers globally. The important "why" and "how" questions, however, are not addressed.

This strategy has roughly stayed in place till today, although under different slogans (or headings if you prefer) such as "The natural source of dairy nutrition for everybody, everywhere, everyday" followed by Volume, Value, Velocity" and "Moving more milk into value added products" being the most recent umbrella statement. Whatever "the flavour of the day" slogan, the increasing emphasis on the Consumer side of the business was a constant. The principal question is: Did the strategy deliver?

Our proven strengths lie in the Commodity/Ingredients business, which has grown but not as strongly as it could have. That was caused by substantial investments directed elsewhere; mainly in Consumer/Food Service and China (farms and Beingmate).

The objective of chasing growth in emerging markets has been overshadowed by the extreme focus on China to the detriment of other countries. We all now know the disastrous consequences of that focus.
Investing in healthy product segments logically implies a strong focus on consumer products. That, however, is not our strength and never will be. I have consistently and convincingly argued that in previous letters.
Streamlining the wide spread of business has not been attempted as the number of product-market combinations continues to increase relentlessly to this day.
And finally, the $35bn revenue goal has quietly disappeared behind the horizon of broken dreams. Total revenue has remained flat at around $20bn since the year 2012. Total volume over that period shows a slight increase from just under 4mln MT to just over that mark (+4.5%)

I leave it to the reader concluding for him- or herself whether the strategy has been successful. To me the answer is a clear No.

4. <u>What are our competitive advantages and proven skills?</u>
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 or our slogan of moving milk into more value added products. These are too broadly defined to be a guiding principle. They are wishes at best. It does not reveal how we are going to do our business and how we want to implement choices.
I find it equally difficult to see how it is different from competitors, either established or emerging ones.
So the hard question is: What makes us different from our competitors? Is it a sustainable difference? And how are we going to successfully build on that difference?

Access to quality milk, an integrated model and great people are often mentioned by board and management but they 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 organisational 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 any strategy.

I do not have access to all the data and information necessary to answer these questions. I feel confident, though, stating that our strengths and skills in the Commodity and Ingredients business can surely make a competitive difference. I feel equally confident stating that our skills and experience in the Consumer business will never do that.

5. The way forward: very much different from today.

I have argued above that thinking in strategic options is not widely practised within Fonterra, leading to sub-optimal strategies and disastrous results as we have recently experienced. And that is putting it mildly.

I claim that Fonterra's guiding principle should be the development and strengthening of an "insurance" structure for individual dairy farmers. Every investment must pass that hurdle.

The history of Fonterra's strategy over the last decade demonstrates a lack of coherent actions and is definitely not based on its unique attributes. It also shows a voracious appetite in growing businesses and expanding into areas, where it lacks proven skills and experience: Consumer and China being the most obvious and most expensive examples. By hiding the actions under "feel good" sound bites and slogans, the board and management could easily escape close scrutiny.

What I would propose is completely different.
First, go back to the drawing board and figure out what our strategy should be. I have given enough tools in order to do that quickly. Particularly if the suggested guiding principle of "farmers insurance" will be applied ruthlessly.

Secondly, focus all our energy on the Commodities and Ingredients business. Invest in R&D, develop advanced ingredients, make preferred supplier arrangements, prioritise process design and improvement and continue to have a strong low cost approach.

Thirdly, try to find a solution for the disposal of our Chinese farms. They must be a valuable asset for somebody but not at the purchase price of our book value of $800 mln. So, be prepared for another loss.

Fourthly, screen all our Consumer business and only keep those that can promise sustainable and sizeable long term profitability. I would not be surprised if only Chile passes the test. An exception could possibly be made for Australia and new Zealand as they are “home” markets that underlie our license to operate and may have to be defended even at a lower profit.

By doing so, at least one of the “old” strategic aims would be accomplished: streamlining our wide spread business.
Not a bad place to start.

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8 October 2018