Student 1: Low Excellence

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Fonterra Co-operative Group Limited is a producer co-operative. It is owned by over 10,000 New Zealand dairy farmers/shareholders. Fonterra's strategic goals are: 1
*[**Strategic goals omitted from this exemplar for space reasons.]***

Apart from farmer shareholders, outside investors are able to invest in units in the Fonterra Shareholders' Fund which gives them access to economic rights (such as distributions and capital movements), similar to those of a share. They do this by buying units which are sold via the stock exchange and can be freely bought and sold in the same way as any other listed security.

Fonterra wants to optimise New Zealand milk production. As farmers cannot supply their milk to Fonterra unless they are shareholders, they are tied to the business ensuring that Fonterra has a steady supply of milk. The business has been able to attract thousands of dairy farmers because they can earn two sources of income from being shareholders. They are paid a milk price based on the volume of milk solids supplied, as well as an annual dividend (40 cents per share in the 2016/2017 year).

The business also helps the member farmers maintain high farming standards, so their farms can be environmentally and economically sustainable. This benefits the farmers and Fonterra into the future. For example, Fonterra offers on-farm advice about improving milk solids through better pasture and different feeds. Fonterra's farmers send their milk to the processing factories and Fonterra exports the milk and sells it on the global market. This means the farmers are working collectively, not competing for exporting profits, to get the best price for New Zealand milk on the international market.

The co-operative structure also reduces risk for farmers as they have support if for some reason they cannot supply the milk they have contracted to supply. For example, if a storm meant that farmers in a certain area had to halt production, the other members could step in and supply the milk that is due. This protects members and minimises the risk they would face if they were in business on their own. 1

As a co-operative Fonterra has many advantages. It has purchasing power. Because of its scale, Fonterra can negotiate favourable terms from its suppliers, of stock feed, farm equipment etc, and pass these discounts onto the farmer shareholders. Another advantage is that Fonterra has marketing power. It can purchase advertising and other marketing costs at discounted rates because of the size of the co-operative. Another advantage is that once a farmer is a shareholder in Fonterra the co-operative is obligated to collect their milk, even if the farm is remote from a Fonterra processing plant and it is not really cost-efficient for Fonterra. 1

A disadvantage for the farmers is that they all get paid the same rate for their milk. It is not possible for any of the member farmers to negotiate a price that is better than other members. Also, Fonterra's marketing is generic so individual farmers might feel they have lost control of unique branding for their farms.

A possible alternative to a producer co-operative is a limited liability company (LLC). Like a co-operative the owners of a LLC are called shareholders, and they also have limited liability. This means that each shareholder's liability for debts that the business can't pay is limited to any amount still owing on their shares. Shareholders in a limited liability company also have two ways of earning from their shares. They can receive dividends (shares of the profit) and they may be able to sell their shares for more than they paid for them (capital gain). Limited liability companies must have at least one share, one shareholder and one director. Some companies are very small, maybe with only family members, and some are very large like The Warehouse. Shareholders in a company elect a Board of Directors to make decisions on behalf of the company. LLCs can keep their financial reports private, but a co-operative has more accountability so must publish annual accounts. 2 6

The big difference between a producer co-operative and a LLC is that a LLC will generally have profit as its main strategic goal. The company will have other goals like sustainability, but its main purpose is to sell its product for maximum profit. To be successful a company will want lots of capital so will want more shareholders. Eventually the farmers in Fonterra LLC could be outnumbered by non-farmer shareholders. Another difference is that if Fonterra became a company a shareholder could sell their shares to anyone, like family members or strangers. They would do this through a share broker. As a co-operative, shareholders could only transfer their shares to other dairy farmers and with the approval of the co-operative. This succession planning ensures that shares are only owned by farmers who will sell milk to Fonterra, giving the business long-term viability. 4

If Fonterra became a LLC it would not be able to meet its strategic goals as easily. For example, sustainability of dairy farms might be given low priority. Providing consultancy advice and on-farm support may be seen as too expensive, especially by a Board of Directors who are not farmers. Although a LLC might demonstrate being a good corporate citizen by making donations, for example, it is unlikely that it would support rural livelihoods and the development of farming communities to the extent that the co-operative does. 4

Shareholders in a company have generally invested because they hope to earn high returns for their shares, not because of a commitment or personal connection to the company. In a LLC there would be non-farmer shareholders who just want to earn dividends from a successful business, as well as the farmers who want an outlet to sell their milk to a world-known exporter. In a co-operative all the shareholders are farmers with common goals and the success and productivity of their farms is linked to the success of the co-operative. But in an LLC the intention to maximise profit would be more important than the interests of the farmer shareholders. 4

I do not consider that a LLC business structure would work for Fonterra. The farmers who supply Fonterra have chosen to supply to them because it is an influential co-operative that gives back to its suppliers in the form of a pay-out at the end of the season, as well as to the community. Most Kiwi farmers associated with Fonterra would not feel comfortable selling their milk to a company for a flat deal, losing the chance to access on-farm support, and losing the buying privileges their shareholding gives them. If farmers want to supply to an LLC processor, they already have the option of supplying to companies like Open Country. 5

A short-term impact of converting to an LLC is that Fonterra would lose many suppliers and a large amount of support from farming communities as they would no longer be able to meet the strategic goals. Additionally, trust from the non-farming community, the consumers of their brands like Anchor, Kapiti and Mainland, could diminish, leading to a reduction in sales and loss of dividends for the shareholders of the Fonterra LLC from the New Zealand market. Overseas consumers of brands such as Anmum are likely to be unaware or wouldn't care whether Fonterra is run as a co-operative or limited liability structure. However, in the mid to long-term the backlash from Kiwi member farmers could cause many brands to not even make the international market due to reduced milk powder volume because farmers are getting less support, or are supplying to LLC milk processing companies that offer a higher base price. 3 4

A co-operative structure has always been best for meeting Fonterra's strategic needs. The business has gained an international profile, has been financially successful and has paid annual pay-outs to its shareholders. However, the business is now in a loss phase. One way of ensuring long-term viability is for Fonterra to remain a co-operative but to promote and increase the number of Fonterra Shareholders' Fund units for non-farmer investors. 5