

Questioning the strategic logic of the Glanbia split

Members of Glanbia Co-operative Society Limited, and indeed all shareholders in Glanbia plc, should think long and hard before they decide to support the splitting of the group as proposed. According to the company's statement, the proposal is 'underpinned by a clear strategic rationale and represents a unique opportunity to transform Glanbia'. 'For the Society and its members such a transaction would offer the prospect of full ownership and control of the key strategic businesses that are closely aligned with their interests. For Glanbia, it would, in particular, increase the Group's focus on international nutritional ingredients and cheese, significantly improve financial flexibility and enhance development of its successful growth strategy'. While no doubt both parties present this move as having a clear strategic rationale, it is not obvious to an outsider how this can be value enhancing, especially from a farmer perspective.

The strategic logic for splitting any business is that the parts no longer add value to each other and would be more valuable as separate units. This means Glanbia has discovered that the international nutritional ingredients and cheese business in which it has invested over the last decade no longer adds value to the parent company and/or the parent company adds nothing to the international division. If this is in fact the case, it is of course better to recognise the strategic mistake now and demerge the group before more resources are lost. However, even if it is true, and it is impossible for an outsider to judge, it is difficult to see how control of the demerged Irish Dairy Division by the coop could hope to realise its value.

The farmers' case seems to be that if the coop, which is currently a holding company, were to have full ownership and control of the Irish Dairy Division that it would manage it better and extract more value in terms of for example milk price than it currently realises. This is a tall order, but to expect it of a coop, and one which as yet has no proven management, is hardly credible. It has been reported that part of the farmers' strategy will be to bring the milk processing assets of Glanbia into a realigned Irish dairy industry along the lines of the Milk Ireland structure proposed by ICOS in 2009. The Milk Ireland initiative envisages a rationalised milk processing structure and a closer link with the Irish Dairy Board for marketing and new product development. Accordingly, the farmers' case is that by bringing Glanbia dairy assets back fully into cooperative hands and linking in with the proposed Milk Ireland initiative it can do better for its members than in the current Glanbia plc structure. Moving from a structure that currently works to a new unproven structure seems extraordinarily risky. Consider the following issues.

The challenge of building a new management for the coop

The coop is coming from a standing start in terms of having a management and a strategy for the demerged unit. The current management of Glanbia plc are highly regarded and Glanbia members know that this level of managerial competence wasn't achieved overnight. The difficulty of building a new management team to manage a business with a new focus should not be underestimated, even if many of the individuals can be drawn from existing Glanbia staff. In particular there is the issue of building mutual trust between the coop board and the new management, as well as the acceptance of the new strategic direction of the coop. Accordingly, the idea that a new management could get up and running quickly and manage the assets better than the existing structure is hard to credit.

Industry rationalisation may not deliver

Farmers should be mindful that the proposed rationalisation of the Irish dairy industry along the lines proposed by ICOS may not be fully realised. ICOS had proposals along similar lines in 1988 and 2000, Department of Agriculture and Food and Enterprise Ireland published recommendations in 2003, and it is understood that ICOS in conjunction with the Irish Dairy Board have recently appointed consultants to conduct a further independent review to report later this year. Of course all of this analysis and advocacy has been influential and the dairy industry has restructured considerably over the years, and is now well structured by general industry standards, but not in the ways or to the extent consistently recommended in the various industry reports. Nor would it be a surprise if the current rationalisation was not fully realised.

Even if the restructuring does go to plan, this would not guarantee savings or greater realisation of value by farmers. The industry is already well structured and processors have been refining this through bilateral cooperative processing agreements so that it is likely that most of the potential savings have already been realised. There is a preoccupation, especially in coop circles, with economies of scale. It seems to be the best understood or misunderstood economic concept. There seems to be the universal assumption that the larger the scale the lower the cost and the higher the profit. This is not the case or the theory; if it was, every industry would be dominated by one or two large firms. The real question is what is the minimum efficient scale for the individual dairy processing activities, how big does a cheese or other dairy manufacturing plant have to be to be efficient? Once the plant size is close to or above this level one is as efficient as another. The evidence from the dairy industry worldwide is that the minimum efficient scale for most activities is relatively low. The issue is more one of having the right size rather than the largest possible. Large scale carries with it reduced competition and adds increased bureaucratic and other costs. Accordingly, farmers should treat promises of higher milk prices arising from rationalisation with a healthy degree of caution.

Inadequacies of the co-operative

Opting for the co-operative structure itself rather than the Coop PLC, however, may be the biggest mistake. As an organisation form the standard coop is not fit for purpose in the modern competitive business environment. The coop suffers from three basic problems. Firstly, members are said to have a horizon problem when investing in the coop because they cannot be sure of capturing all of the benefits of their investment. Other members who use the coop more or who contribute less to its capital may realise more than their fair share, and the benefits will also be shared with future members. The expected effect is that farmer members will under-invest in the coop and that longer term and knowledge assets such as research and development, new product development and marketing will suffer most.

Secondly, members of coops, in so far as they are required to invest at some minimum level in their coop, have what is called a portfolio problem. They are required to take on investment risks that in an ordinary company could be shared with outside equity investors. Again this would predict underinvestment in the coop.

The third problem is the coop's poor capacity to guide, incentivise and monitor its management. It is widely accepted that the objectives and interests of managers differ from

those of shareholders. This is referred to as the 'principal-agent' problem and is encountered in all organisations where managers (agents) conduct business on behalf of shareholders (principals). However, it is considered to be more severe for coops for a few reasons. Because of their small individual shareholdings, coop members and even boards of directors have a low incentive to innovate or to take unpalatable decisions such as disciplining management or initiating management change. Furthermore, coops cannot easily use share ownership and share option schemes to incentivise and compensate management, and the absence of a market in the shares is a further control handicap in that it deprives members of an objective means of monitoring the value of the coop and this adds to the difficulty of evaluating the performance of management.

The innovative Coop PLC

For these reasons most progressive agricultural coops throughout the world have modified their structures, some converting completely to joint stock companies, and others adopting hybrid company/coop forms, of which there are many. The Irish hybrid, the Coop PLC, conceived of by Kerry Co-operative in 1986 and known internationally as the Irish Model, has been one of the most successful. Its formation by the management and advisors of Kerry was a truly entrepreneurial event and has been responsible for unlocking enormous potential in the Irish food industry. From a very inwardly focused sector controlled by the coops and heavily dependent on subsidised products, we now have a number of outstanding food firms that are maturing into high value international enterprises. Arysta (formerly IAWS) and its subsidiary Origin Enterprises, Glanbia itself and Kerry Group are by any standards outstanding international food businesses.

The Coop PLC provides a solution to the horizon problem by allowing shareholders full access to the true value of their equity. It deals with farmers' portfolio problems by attracting outside equity holders who share the business risk and providing an additional source of equity finance. It deals with the management control issue through the public company's requirement to have a transparent reporting to shareholders and to the public. Its performance is adjudicated on continuously by many equity analysts and reflected directly in the market price of its shares. Share option schemes and other equity incentives are available to incentivise and align management with the objectives of the firm.

The Coop PLC offers farmers the opportunity to participate further downstream in the dairy supply chain through equity investments at whatever level suits their personal circumstances and risk preferences, and through a high level of farmer director representation on Coop PLC boards. However, like all business and investment relationships, trust between the different stakeholders that each is getting a fair deal is all important, and in the case of the Coop PLC there is the challenge to manage the potential conflict between farmers as raw material suppliers and the firm's equity investors comprising both farmers and outside equity investors. Up to now the Coop PLCs have achieved a good balance between all of the interests concerned, but this seems to have failed of late at Glanbia, where at least some farmers now feel they can achieve a better deal by managing some of the assets themselves through the coop.

Fonterra Coop is often held out as the model to emulate, but had the Irish dairy industry adopted the New Zealand model we would now have a single large dairy co-operative exporting commodity products having sales of about €3 billion and employing about 5,500

people. It would have no competitors to speak of, there would be no way of assessing its performance, and farmers still wouldn't know whether they were getting the best price for their milk. We would have no Kerry Group, no Glanbia, and probably no Arzsta or Origin Enterprises, who between them employ 35,000 people worldwide.

Fonterra has recently announced its intention to become 'a true international food firm to rival Nestle and Kraft', but was disappointed when only 30% of its farmer shareholders responded to a cash call to fund the new strategy. It is now realising that it too must look to outside equity investors or scale back its expansion plans. Fonterra is about at the corporate development stage that Kerry Group had reached 15-20 years ago.

Farmers' milk price expectations may be unrealistic

Before signing up to such a drastic move as splitting the group, Glanbia farmers should not only satisfy themselves that they can manage the assets and the future development of the Dairy Ireland Division better than the current management, but also that their expectations for milk prices are realistic. There is good information on milk prices from the Irish Farmers' Journal milk league, and to inform this discussion, the monthly cash prices paid in 2008 and 2009 by the three leading processors, Glanbia, Dairygold and Kerry were compared. It should be stated however that farmers may derive other benefits from their milk processors that are not fully reflected in the milk price reported. In 2008, all three firms paid prices within a 2% band with Dairygold at the upper end, Glanbia toward the lower end and Kerry about 0.5% above Glanbia. This seems to confirm that Glanbia was paying going market price, or at least very close to it in 2008. However, when international dairy product prices collapsed in 2009, and average prices paid to Irish farmers fell by a staggering 35%, processors varied in the extent to which they cut farm prices. Glanbia and Dairygold each paid exactly the same average price in 2009, but Kerry cut prices a little less leaving its average about 7% above Glanbia and Dairygold. The question is was Glanbia still paying the market price in line with Dairygold and Kerry paying over the odds, or was Kerry nearer to the market price and both Glanbia and Dairygold underpaying in 2009.

While the milk price data are probably not robust enough to confidently conclude one way or other, it seems more likely that Glanbia was paying below rather than above the going market price, in which case farmers would have a legitimate argument for a somewhat higher payout. However, this should be easily agreed through negotiation, based on the evidence, rather than going for the nuclear option of splitting the company.

If an objective assessment was that the company did underpay the going rate, Glanbia management must answer why suppliers were underpaid. On the other hand if an objective assessment was that Glanbia did in fact pay the going rate, but farmers expected more, then the farmers' claim was unreasonable. In a competitive market, the only way that a higher than average product price can be achieved is when the product concerned delivers benefit out of the ordinary that the market values. Accordingly, achieving above average prices for normal milk is an unrealistic expectation, it can only be achieved by some manipulation of the market and gains at the expense of other stakeholders. For example, it would be inequitable between stakeholders in Glanbia if the company was to pay higher than average milk prices to its suppliers while it could source such milk on the market at average prices. Put another way, farmers as shareholders would feel aggrieved if Glanbia was to pay over the odds to its staff, or pay higher than average interest rates to its banks, or to pay other

suppliers for something that they didn't deliver. Of course farmers as shareholders share directly in the profit of the business and therefore in any gains or losses associated with under or overpayment. These are the legitimate rewards for providing risk capital to the enterprise.

Neither will converting to a coop change this reality, there are no free lunches. If farmers through the coop wish to pay themselves over the odds for their raw material, they will do so to the neglect of others aspects the business, most likely by under investing in its future. Good intentions to invest in for example new products, research and development and marketing would inadvertently be sacrificed to support the milk price. This would augur poorly especially for the future of the consumer foods division of Glanbia. One could see this being neglected over time and even sold following the example of Dairygold Co-operative.

A further concern is that the new trading Glanbia coop could start out with a strong balance sheet, a legacy of the high value that has been built up through good performance of the PLC, only to distribute this over time in support of the milk price. Farmers who have higher shareholdings in the coop but perhaps are smaller milk producers, and so called 'dry shareholders', should be especially concerned about this inequity because their equity would be distributed on the basis of milk supply rather than share ownership. Shareholders in the coop would no longer be adequately compensated for their risk taking. Milk producers would capture more of the benefit, but shirk some of risk. In the extreme, the coop could be rundown and fail and its equity become worthless, but milk suppliers would still be free to go elsewhere with their milk.

Realising best value for all shareholders

Aside from the issue as to whether the demerger is necessary, whether best value is being achieved by the division now proposed should be a concern for all shareholders, farmers and non-farmers. Following the merger of Waterford and Avonmore more than a decade ago, the parent company, which has one large shareholder, Glanbia Coop, set about integrating the two units by restructuring and refocusing its activities. This involved considerable investment in rationalisation, disposal of non core activities, many of which were acquired earlier by one or other of the merged units, and the acquisition of new businesses deemed to be core to the new Glanbia. This strategy met with considerable success especially the building of the international nutritional ingredients and international cheese businesses, but now the company has discovered that this is not really core after all and should be split off, or more accurately it should become the new core.

This is rather strange logic. Having discovered that the international business did not add value to the parent, a more logical decision would be to selloff the international unit for cash, and following perhaps a pro rata reduction of the Group's debt, distribute the proceeds to shareholders. The scaled down business would then continue to trade as Glanbia plc and proceed to grow its core activities again and more astutely diversify into related businesses that clearly added value to the core.

However, to be confident of getting full value for the international business, it would be preferable to have more than one interested party. The current management, who have expressed interest in going with the international unit would be in a very strong position to mount a bid, and perhaps the unit would be less valuable without them, but an important

question for shareholders is whether there are other parties who would be interested in buying this business.

Other ways of increasing the likelihood of getting full value for the demerged group would be to establish a new public company for the international unit with the Coop PLC retaining an equity interest, and structures similar to Arysta and Origin Enterprises, or Fyffes and Total Produce come to mind.

While it is difficult to judge how physically divisible the various units of the company are and what adds value to what, the value of the consumer foods unit would seem to be most in jeopardy if split off as part of the coop. While investment in physical processing capacity might be considered a priority for the coop, investment in research and development, new product development and marketing would be much further down the pecking order. Selling the consumer foods part at this point might be the best way to realise its full value.

None of these options would be necessary if the structure were to remain as is, but it would be necessary to allow the coop shareholding to drift down over time by gradually converting coop shares to PLC shares. This would allow members of the coop realise the value of their equity in the coop as their personal circumstances may require. Kerry Group has successfully done this over the years. It might also be desirable to have better ground rules for deciding the milk price, and a full understanding that the legitimate level is the average market price.

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