

Bright outlook for global dairying

Fonterra chairman Henry Van Der Hayden was in Ireland recently for a working holiday and he shared his views on world milk production with **Pat O' Keffe**



Fonterra chairman Henry Van Der Hayden, speaking in Ireland recently.

Provided world economic growth continues at its current healthy rate, Irish dairy farmers can be optimistic about the prospects for milk price over the next five to 10 years.

That's according to one of the most influential men in world dairying, Henry Van Der Hayden. He is chairman of Fonterra, the New Zealand cooperative that is the largest player in international dairy trade.

In the coming years, Van Der Hayden's co-op will have the greatest influence on the price received by Irish dairy farmers.

Why? Only 6% of the world's milk production is internationally traded. Of that 6%, Fonterra account for 40% and their influence is increasing through international joint ventures and expansion.

talk about price another day."

What is your assessment of the dairy market outlook?

"The Fonterra view, supported by Rabobank and others, is that the trend globally for the consumption of milk is for demand to be stronger than supply. Milk is positioned around health, nutrition and wellbeing — you have the global market driven by China and India growing at 3% a year. You have very high oil prices, so you have strong demand coming out of the Middle East and parts of South America. The question we keep asking ourselves is — where is extra supply going to come from the next five to 10 years? We are doing a lot of our strategic thinking around that.

"So the combination of strong demand and no major growth in supply means upward pressure on price — we've been saying that for two to three years now. The growth areas that we see for both supply and demand are China, South America and possibly Eastern Europe.

"The strongest growth will be in liquid, but there will also be growth in ingredients but very slow growth in cross border trade.

"On the supply side, we have the Australian drought and the ethanol story, both in the US and in Europe. So right now, there's a real shortage of dairy production, particularly proteins. So we're seeing very high prices for skim milk powder. If you had asked me six months ago

if we'd have seen these prices, I'd have said 'no way'. So I don't think anyone saw that coming.

"If you look forward, at least to the end of 2007, we see these strong prices continuing. Like anything else, supply and demand will set the price. You will see something happen — either a demand response (a slowing) or a supply response (an increase somewhere). So, in the next six months, a lot of certainty about prices, but further out, no one really knows.

"But in general, we see strong global demand into the future."

Are the relatively high prices going to have adverse effects on demand?

"We are talking about high prices in US dollars, but a lot of customers are buying in their own currency and the dollar has weakened so they are not feeling the full impact. That's dampening the effects for some. Then, if you look at the oil producing countries, there is quite a bit of cash around.

"I think generally food is going to be priced at a higher level, because the world concern now is around energy, rather than feeding its people."

What are the clouds on the horizon for dairy markets?

"I think the main risks are:

- 1) A demand response to higher prices
- 2) For us, currency is a huge issue. Our currency has doubled, so where that plays out is hugely important. I think if the global economic growth continues at three or four per cent per year, then there are no black clouds on the horizon."

Is China increasingly important to Fonterra

"I think that at these milk prices, the Chinese will be consuming liquid rather than

other (imported) dairy products. We've actually seen a decrease in exports (to China) and a strong growth in their fresh milk market."

What involvement has Fonterra in China?

"We have three businesses there — our exporting business, which is mainly whole milk powder and skim milk powder. We have also taken a 43% stake in a company called San Lu which is mostly in infant formula powders and investing in the growth area of yoghurts. We have also set up a farm park there where we want to get involved in producing our own milk."

Is that your first venture into direct production?

"Production of milk, yes. We also have some research farms in Chile."

Is that part of the future for Fonterra?

"As long as we can make money out of it, and that's yet to be seen. It's a toe in the water to build up the capability in those areas."

I hear criticism that Fonterra could influence markets a little better.

"I travel around the world quite a bit. Farmers around the world all want the same thing — a bloody good milk price. So there is alignment in our business objectives. So we've got to work out ways how we can actually achieve this. If you take a globalised world, we should be working together, rather than against each other."

But reports suggest that Fonterra is undercutting others and selling at prices far lower than others? Is that a fair criticism?

"Let's not forget, our farmers produce about 15 billion litres of milk. We make business decisions around optimising the price around that."

Van der Hayden's views on Ireland

"When I come to Ireland and I see all that pasture, the soils and the climate, I see a very bright future here in agriculture and particularly milk."

"Into the future I think Europe will be more integrated into the global marketplace. I see quotas being removed and a much more free market with lower tariffs.

"I see a great opportunity for the Irish dairy industry, but it must position itself around global competitiveness. "If the mindset is defensive and trying to protect the status quo, the risk is that the world moves by without you.

"I see real opportunity for you to seize the opportunity on the global market."

With the reduction of export refunds to zero, the pace of change has been phenomenal.

"I think the pace of change will get faster, not slower. The key thing is China. It's actually starting to change the face of the world and it's about size, scale and pace of change."

Ireland has a number of relatively small processors compared to the New Zealand industry. Do you think we can compete in that form?

"If you look at what the world will be like in 10 years time — no subsidies, reduction in tariffs, Europe integrated into the global market, then how would you position the Irish dairy industry? I don't think you would keep the current map.

"The current map looks as if Ireland is the core and Europe is the market. If you are

looking at the global market, then it needs to evolve."

But aren't the small co-ops in New Zealand paying a better milk price than Fonterra? Who needs scale?

"That's such an important question to ask. The mindset of the New Zealand farmer wants two things.

"Milk price first but they also want to have value, so they want their co-op to have a growth strategy that delivers value.

"That's why we have the Fair Value Share, which is recognising value."

How has the average New Zealand's farmer's Fonterra shares grown in value?

"The average share has gone from \$4 per share in 2001 to \$6.79 today. So we are measured on milk price and share value."

Ireland and New Zealand are very similar. Could you see Fonterra investing in Ireland, particularly in a quota free environment?

"I position it slightly differently. I see quite a few strategic opportunities for Irish and New Zealand companies to work together once you have a global mindset."

But you don't rule the idea out?

"With the mindset and the entrepreneurial flair, I do see some opportunities, but it might not be in my lifetime. We work very closely with Glanbia now and there is a good strong working relationship between Fonterra and the Irish Dairy Board."

Q&A

It must be a great time to be selling dairy products?

"I'll be quite honest — today the discussion with the customers is less about the price but is about security of supply. They are concerned today about where they are going to get product from. They want us to guarantee them their supply and we can

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Governance structure

FONTERRA has a board of directors as well as a shareholders council. Can you explain the difference?

“Our structure involves a board of directors that focus on the commercial outputs. That’s their sole responsibility. Strategy and grow the value of the business. Optimise and maximise the value of the milk. The shareholders’ council deals with the representation issues and the softer issues of the co-operative.”

Are you happy with that structure?

“I am very positive as it allows the directors to focus on the global market, while it allows the council to keep farmers happy.”

How do you elect your directors?

“Our directors are elected in a vote amongst all farmer shareholders.”

There is no geographic split?

“No. Geographic means representation. For the shareholders council, there is geographic.”

When you spoke at the ICOS conference in 2005, you said it was crucial for Fonterra to identify and train potential future directors. How has that progressed?

“It’s good. We’ve done two things. For the national director elections, we put out what we call a scorecard around the competencies of the directors standing. On that committee are two directors, two from the shareholders council and an

independent chair. They measure each candidate on five competencies: communication; governance; experience; strategic mind; understanding financial accounts.

“Secondly, we are identifying governance options 10 years down the track and putting those people into training. Young people, aged 30-35. Hand pick them, put them through courses and take them to the international marketplace and start them thinking.”

What about Fonterra’s capital structure?

“Capital structure is the big issue in front of the board. We are pursuing a growth strategy and the existing capital structure presents a number of risks to the business. For example, redemption risk, where a large number of farmers seek to sell their shares. Another issue is that the average farmer has about €400,000 tied up in Fonterra.

“Is it really fair that every time they expand production they have to put more money into the co-op? We think our farmers should have more investment choice. The other issue is, where are we going to get the capital for growth?”

Is stock market floatation an option?

“All options are on the table. What I can say is that, whatever we do, farmers will control the business. That’s actually a given. They want control.

“The board will present options to farmers this September and a vote is likely early in 2008.”

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— Henry Van Der Hayden



Where now for Fonterra?

A growing proportion of Fonterra’s milk is now sourced outside of New Zealand. Will that trend continue?

“Strategically we want to source more milk, but we are actually going to be sourcing less. For example, production coming out of Australia will be less. In the US when they had 550,000 tonnes of skim sitting in the caves in the Mid West, a lot of that went through our supply chains.

“But now, you will only have the surplus going through our supply chains.

“Go back 10 years, we were growing somewhere between 5% and 6%. Since Fonterra was formed in 2001, our compound annual growth rate has been about 2.8%. The year we have just finished, production grew by 3%. The year just started, subject to weather, we expect to see quite strong growth again.

We have seen just under 100 new farms come into Fonterra. That’s a consequence of positive global dairy markets against nega-

tive global sheep meat markets. We also have a lot of enquiries for 2008/2009.

“In the medium term, three to five years, I think we will still keep growing at that 3% rate.

What are the constraints?

“Right now the constraints are probably resources around building new dairies and those sorts of things. If you take a broader view, there are issues around regulation, water, environment, climate change. Also land use — you are getting more lifestyle blocks.”

Are the days of 5-6% per annum growth in New Zealand and milk production over?

“Yes. It’ll be 2-3% growth in the short to medium term.”

Has scale at farm level continued to grow?

“Our average supplier now will be 300 cows. The number of farmers is also falling quite rapidly. When Fonterra was formed in 2001, there was 13,000. Now it’s about 11,000.”



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