



New Zealand's big farmer cooperatives collectively earn more than \$24 billion of New Zealand's annual GDP of \$203 billion. They walk a tightrope between keeping shareholders happy and sourcing capital for growth, but they may provide a sustainable business model for a world in financial meltdown. By **Andrea Fox**

THE FACE OF THE

future

Could the cooperative business model turn out to be the Susan Boyle of the stricken global financial stage? The frumpy, awkward Scottish songbird, who shocked the socks off cynical British talent quest judges and went on to captivate a hardened internet audience, had us all re-examining our values.

The current financial crisis and the rampant greed that prompted it suggest there is a compelling case to embrace a business model that respects human values – the cooperative enterprise.

New Zealand looks to be halfway there. Its largest company, Fonterra, is a dairy farmer-owned cooperative; five rural cooperatives are among the country's top 20 companies; and the largest grocer, Foodstuffs, is also a cooperative. However, despite the fact Fonterra earns 25% of our total export returns, and one in three New Zealanders is a member of some sort of cooperative, according to the International Cooperative Alliance (ICA), NZ Inc's understanding of the cooperative way of doing business is underwhelming.

Like Susan Boyle, cooperatives have a dowdy, old-fashioned image with a hint of socialism about them. And they are strongly associated in the national psyche with that other Cinderella – agriculture – a sector largely ignored by urban New Zealand until the economy needs propping up.

Cooperative balance sheets, and rebate and payout systems tend to mystify the capital markets camp, but there's no denying the model's economic staying power. In the UK, cooperatives opened shop 165 years ago in response to the industrial revolution, which spawned the market society and dramatically widened the gap between the powerful and the powerless.

In New Zealand, the first dairy cooperative was formed 138 years ago in Otago. By the 1930s, there were more than 400. Cooperatives flourished in the 1860s and 1870s, when banks collapsed and "the excesses of the free market and unbridled capitalism treated people and economies in a very cavalier fashion", says Christchurch financial academic and cooperative analyst Alan Robb.

The five rural cooperatives in the top 20 New Zealand companies by turnover are Fonterra, meat companies Silver Fern Farms and Alliance, and fertiliser heavyweights Ballance and Ravensdown. Collectively they earn more than \$24 billion of the annual GDP of \$203 billion.

Dairy cooperatives Tatua and Westland earned nearly \$700 million between them last year, and rural retailers Farmlands and the South Island's Combined Rural Traders more than \$900 million. The world's biggest agriculture bank, Rabobank, is a cooperative, lending around \$7 billion to the farming sector in New Zealand last year.

You can argue until the cows come home about the efficiency of a rural cooperative business compared to a listed or unlisted investor-owned company, but it would be a waste of breath, because you wouldn't be comparing like with like, say the experts. Because cooperatives focus primarily on the needs of members, they have been prudent and "avoided the excessive risk taking that plagued many large global financial institutions", according to UK social scientist Johnston Birchall.

Of course, cooperatives can lose their way, too. Fonterra, the world's biggest dairy trader, is in trouble with the purists as it grapples with the biggest challenge for any rural cooperative – accessing capital for growth. To maximise returns to its 10,000 farmer-owners, Fonterra needs to keep growing offshore. Growth requires capital and its farmer-owners don't have bottomless pockets. Fonterra's current debt gearing tells a story: by the end of January it had risen to 61.5%, from an already uncomfortable 57.4% in July last year.

Fonterra directors, trying to get some stronger commercial measures into the business without stampeding sacred cows, have won farmer acceptance for a 'fair value' system for the company's shares, replacing

the traditional cooperative ticket of '\$1 in and \$1 out when you leave'. Farmers have to buy a share (at a price evaluated annually by outside consultants and based on a discounted value of expected Fonterra earnings) for every kilogramme of milk solids supplied. The average herd produces 100,000kg each season.

Cooperative purists say it was a device to soften up farmers for an eventual public listing. Accountants say a share price that isn't based on the fair value of Fonterra's net tangible assets is unsustainable, because farmers who leave will take more than the business can afford to give them.

Whatever, it's not working. Share prices have proved too rich for farmers wanting to increase production, or a temptation to cash up and turn to one of Fonterra's emerging competitors that doesn't require farmers to buy shares to supply. Even today, with well over \$1 billion wiped off farmers' share values by recent economic events, the shares are a stretch for farmers in financial distress because of a slashed milk payout and the credit squeeze.

Hell hath no fury like an insecure cooperative owner, as Fonterra directors found last year when they proposed a capital restructure that involved publicly listing part of the business. As usual, 75% member support was needed for change. But farmers saw red and directors retreated under heavy fire. Punishment came in later elections when a farmer director was dumped. (Somewhere along the way, Fonterra chairman Henry van der Heyden weirdly accepted a job as a director of the New Zealand Stock Exchange.)

The word is directors are ready to announce a new plan. It's under wraps until farmer-shareholders have heard it, but van der Heyden will be pushing hard for a resolution by Christmas, hoping economic fears and uncertainty will work in the board's favour. They could also send members running for safety back to pure cooperative principles.

Silver Fern Farms announced recently, after an abortive merger with listed rural services company PGG Wrightson, that a capital restructure would now see new shares issued to existing farmer shareholders, rather than the public.

Fonterra Shareholders' Council chair Blue Read says farmers know a commodity business cannot generate a consistent level of profit every year. "The reason co-ops were set up was because traders made the money and farmers, being at the bottom of the heap, got what was left after everyone else had taken a cut of profit.

"The co-ops made sure farmers could control as much of that line of profit as they could, and also guaranteed, particularly in the case of milk, [their product] would be picked up every day and processed and sold to market, irrespective of its value to anybody else."

Fonterra is dealing with an evolution, says Read. "It's not something we should be fearful of as long as we retain our traditional cooperative values, which are around a control quotient, and the certainty of payment for our product, and standards of treatment of our supplying shareholders."

NZX chief executive Mark Weldon likens the debate about the capitalist market versus the cooperative system to that between opposing sides in the abortion forum. "They talk at each other, rather than to each other. Where capital markets have miserably failed is in not trying to understand cooperatives but telling them what do. These are businesspeople in their own right. Running a farm is the same as running a business; it just happens to be incorporated differently."

The major weakness of the cooperative model, says Weldon, is in its singular dependency on banks. "The global banking system has changed. Regulations mean it will continue to change. The cost of funds from banks is going up; the level of covenants banks are putting onto corporate is increasing." →

What are cooperatives?

AND WHY THE MODEL
COULD SAVE OUR SKINS

IN A recent paper on the significance of cooperatives to a world in crisis, UK social scientist Johnston Birchall explains, "Cooperatives are member-owned businesses. The simplest way to understand them is that they aggregate the market power of people who on their own could achieve little or nothing, and in so doing they provide ways out of poverty and powerlessness."

The International Cooperative Alliance (ICA) has 800 million members in more than 100 countries. It defines a cooperative as "an autonomous association of persons united voluntarily to meet their common economic, social and cultural needs and aspirations, through a jointly owned and democratically controlled enterprise".

Birchall says of cooperatives, "Because they are democracies with each member having one vote, they empower people to own their own solutions, and because they pool risks at the level of the enterprise and offer micro-insurance they increase security." He notes one of the biggest challenges to cooperatives is the lack of awareness of their business potential amongst governments and the general public.

Alan Robb (right) says cooperatives are not well understood because the business model isn't widely taught at tertiary level, but the system isn't rocket science.

"Cooperatives don't seek to make a profit on capital. They are either trying to provide inputs to farmers at the lowest cost or, like Fonterra and the meat companies, to get the highest return for farmers for their products. They usually keep part of the [annual] surplus for a buffer and for growth of the business, and the balance is distributed to members in proportion to their transactions within the organisation."

The ICA's latest list of the world's top 300 cooperatives (with total annual revenues of NZ\$1.1 trillion) includes six New Zealand cooperatives. Three are the regional Foodstuffs supermarket companies (Auckland, Wellington, and the South Island). The other three are rural cooperatives: Fonterra at number 27; and meat companies Silver Fern Farms at 166 and Alliance at 278.





Rural cooperatives exist so farmers don't get left with the scraps, says Fonterra Shareholders' Council chair Blue Read

Weldon also advocates a 'clean sheet of paper' approach to business models after 18 months of massive change. "The days of a strong balance sheet being called a lazy balance sheet are well and truly gone."

The issue with cooperatives is not whether their business model is right or wrong, but where they go next, says Rob Cameron, investment banker and chairman of the Capital Markets Taskforce.

"There are good and quite powerful reasons for them. The fact they have persisted tells you that alternative forms of service and supply haven't worked for them, so the issue becomes how to help them evolve ... maybe to get bigger. That evolution may be about the business model or their ownership architecture, or both."

Cameron's government-appointed taskforce is to produce a plan to develop New Zealand's capital markets. His company, CameronPartners, has provided advice on strategy and capital structure to cooperatives including Fonterra, Silver Fern Farms, Livestock Improvement and kiwifruit marketer Zespri.

While New Zealand's listed debt market is active, its equity market is small by any standards, he says. "We don't know the complete reason for that, but some reasons are that a lot of the assets you'd expect to be listed are owned by central and local government, and the other reason is that co-ops are a big part of it. We seem to be less successful than other countries in bringing our smaller private firms through to being bigger firms on the market."

Other challenges for the rural cooperatives are to get fitter and faster.

The cooperative way, says van der Heyden, isn't to be nimble – witness Fonterra's meandering capital restructure journey. It's a cliché, but the world is changing. Van der Heyden says rural cooperatives dealing in export must have a global strategy that can evolve with such change.

"I think the world will change for a long period of time now and companies won't be so heavily leveraged again. So how does a cooperative structure itself for that new environment? It's back to the capital structure again."

Cameron predicts evolution within cooperatives will be driven by pressure from stakeholders, markets and their own success. They will have to get bigger to deal with scale and new markets.

"People need to be comfortable with the change ... When outsiders are providing capital other than debt, they need to be comfortable, they need to ensure stability and, if it doesn't work out, they need to know how they can put Humpty back together again."

"Yes, it is a time of great opportunity – not just for cooperatives, but for their businesses ... If they don't address the problem of change quickly enough, they will miss out on those opportunities."

For Blue Read, the single biggest challenge for New Zealand's rural cooperatives will be sourcing capital while keeping their stakeholders "happy and involved in the business".

"It's more about satisfaction. Satisfaction drives success more than money does. With the right set of values and the right understanding within an organisation, it will prosper."

5