

**Pacific Rim Real Estate Society  
Conference 2000**

**Sydney, January 23-27, 2000**

**THE NEW ZEALAND DAIRY INDUSTRY –  
STRUGGLING TO RESTRUCTURE**

**IONA McCARTHY**

Department of Finance, Banking and Property,  
Massey University, Palmerston North  
New Zealand

Phone: 64-6-3505799-7472, Facsimile: 64-6-3505651,  
Email: [I.A.McCarthy@massey.ac.nz](mailto:I.A.McCarthy@massey.ac.nz)

**Keywords:** dairy industry structure, dairy company shares, farmland value,  
unbundling

## **INTRODUCTION**

Conflict between profit and power is evident as the New Zealand dairy industry restructures. This paper examines recent and proposed restructuring of the New Zealand dairy industry and questions who will benefit. Recent and proposed changes to shareholding are outlined and threats resulting from these changes are raised and implications discussed.

## **INDUSTRY STRUCTURE & RESTRUCTURING**

The New Zealand dairy industry is owned and controlled by the supplying farmer shareholders. It operates as a vertically integrated co-operative with separate manufacturing companies supplying one marketing company. With this structure, farmers have the security of guaranteed purchase of product, the advantage of scale with a single seller, and the additional benefits of support services and research and development programmes. However, in recent years real returns to farmers have declined and the efficiency of the current structure is being questioned. Inefficiencies have become evident as individual dairy companies duplicate ancillary activities. It is likely that a reduction in the cost of delivery of some services could be gained with economies of scale. There are further inefficiencies in the allocation of production between manufacturing plants.

There is also concern about the continuing and escalating demand for funding the development of the industry. This is becoming an increasingly important issue in the areas of manufacturing and marketing. Historically development of the dairy industry was financed through retained earnings and discounted finance provided by the Government. The industry lost Government funding in the early 1980s and since that time has faced the challenge of financing large increases in production. Rapid growth through the mid 1990's meant a large additional investment in processing capacity and marketing was needed. Retention to payout cannot be relied on to finance the growth and a different means of raising equity is required.

It has further been argued that the regulated monopoly could limit access to some markets. Deregulation of the industry has been promoted as a way to gain improved market access. The likelihood of deregulation started a power struggle between dairy companies. A company needs a minimum of 25 percent ownership in the Dairy Board for power of veto. This has prompted rationalisation of the industry through merger activity in the 1990's. In 1995 there were fifteen manufacturing companies in New Zealand; now, in January 2000, there are seven. New Zealand Co-op Dairy Ltd (NZCD) and Kiwi Co-op Dairies Ltd (Kiwi) have emerged as the two main players, both working to gain a power advantage. This was most obvious in 1998 when both companies sought to merge with South Island Dairy Co-op Ltd (SIDCO). NZCD (currently with 58.2% ownership of the New Zealand Dairy Board) and Kiwi (currently 36% ownership of the New Zealand Dairy Board) are now in negotiation to form a mega co-operative.

Table 1. Shows the percentage ownership of individual dairy companies in the New Zealand Dairy Board and highlights merger activity that has occurred in the New

Zealand dairy industry since 1996.

Dairy Company <sup>1</sup>	1996	1997	1998	1999	2000
Alpine Dairy Products Ltd	<b>5.1</b>	<b>5.6</b>	<b>6.9</b>	<b>SIDCO</b>	
Anchor Bay Holdings Ltd (Bay Milk )	<b>5.9</b>	<b>6.1</b>	<b>6.0</b>	<b>NZCD</b>	
East Tamaki Co-op Dairy Co Ltd	<b>1.0</b>	<b>NZCD</b>			
Kaikoura Co-op Dairy Co Ltd	<b>0.3</b>	<b>0.3</b>	<b>0.3</b>	<b>0.3</b>	<b>0.3</b>
Kiwi Co-op Dairies Ltd	<b>16.3</b>	<b>25.7</b>	<b>26.9</b>	<b>27.3</b>	<b>36.0</b>
Marlborough Cheese Co-op Ltd	<b>0.5</b>	<b>0.5</b>	<b>0.5</b>	<b>0.5</b>	<b>0.5</b>
Northland Co-op Dairy Co Ltd	<b>9.5</b>	<b>9.7</b>	<b>8.6</b>	<b>8.7</b>	<b>Kiwi</b>
NZ Co-op Dairy Co Ltd	<b>41.4</b>	<b>40.4</b>	<b>39.7</b>	<b>43.4</b>	<b>58.2</b>
Otago Co-op Dairy Co Ltd	<b>1.2</b>	<b>1.2</b>	<b>Kiwi</b>		
South Island Dairy Farmers Ltd	<b>0.9</b>	<b>0.7</b>	<b>0.9</b>		
South Island Dairy Co-op Ltd				<b>14.8</b>	<b>NZCD</b>
Southland Dairy Co-op Ltd	<b>4.5</b>	<b>5.0</b>	<b>5.4</b>	<b>SIDCO</b>	
Tasman Milk Products Ltd	<b>1.3</b>	<b>1.4</b>	<b>1.5</b>	<b>1.5</b>	<b>1.5</b>
Tatua Co-op Dairy Co Ltd	<b>0.9</b>	<b>0.8</b>	<b>0.8</b>	<b>0.8</b>	<b>0.8</b>
Tui Milk Products Ltd	<b>9</b>	<b>Kiwi</b>			
Westland Co-op Dairy Co Ltd	<b>2.3</b>	<b>2.5</b>	<b>2.5</b>	<b>2.7</b>	<b>2.7</b>

**Table 1. Percentage Dairy Company ownership of the New Zealand Dairy Board, 1996 to 2000**

The optimal structure for the future of the New Zealand dairy industry has been investigated and reported on in a series of industry studies.<sup>2</sup> These studies recommend that the assets of the Dairy Board and the assets of the participating dairy companies be amalgamated into one mega co-operative; to manufacture all raw milk, market all commodity products under a co-operative structure and market the high value consumer products under a corporate structure. Farmer shareholders and industry leaders appear to favour formation of a mega co-operative but formation is dependent on four factors. First the Dairy Industry Restructuring Bill has to be passed. This legislation enables the removal of the statutory powers providing for a single exporter for New Zealand dairy products. Draft legislation has been introduced and will expire on 1 September 2000. Second, NZCD and Kiwi need to agree to merger terms. Talks and analysis of the value of companies continue but political issues are slowing this process. Third, Commerce Commission approval has to be obtained. The Commerce Commission declined the formation of the mega co-operative in August 1999 and requires further information to support the merger. Finally, supplying shareholders of the merging companies' vote on the proposed merger and 75% support for the merger must be achieved.

<sup>1</sup> Source; NZ Dairy Board Annual Reports, 1997 to 1999

<sup>2</sup> One Company Study (1994/95); Industry Efficiency Improvement Study (1996); Business Development Project (1997-1998); NZ Dairy Industry Strategy Review (completed January 1999); NZ Dairy Industry Structure Review (completed May 1999).

Progress towards formation of a mega co-operative has been slow, initially because of failure to gain Commerce Commission approval, and more recently as NZCD and Kiwi attempt to gain the greatest comparative advantage.

Industry reports providing analyses of the benefits of rationalisation are not publicly available. Brief details have been released to the media stating that immediate annual benefits of \$250 million are possible. Future benefits of industry growth from annual earnings of \$8 billion to \$40 billion over a ten-year period are expected. The Commerce Commission has had access to industry reports and their preliminary view has been to decline the proposed merger. The Commission did not accept many of the benefits claimed in the industry reports and argued that they could be gained without the proposed merger. The Commission's initial financial assessment states that detriments could be between \$138 - \$527 million a year, while benefits likely to flow from the proposal could amount to between \$26 - \$92 million a year.<sup>3</sup>

The Commerce Commission is also concerned that NewCo (the mega co-operative) will potentially have control of all milk produced by farmers and there is no requirement that NewCo provide fair value entry and exit opportunities for farmers. The Commission also noted that dominance in the processing and wholesale supply of town milk could be detrimental to domestic consumers.

### **CHANGES TO DAIRY COMPANY SHARES**

The increase in share standard is an important factor in recent industry restructuring; introduced to fund industry growth and allow the Dairy Companies to pass on shares in the New Zealand Dairy Board following the 1996 amendment to the Dairy Board Act.

Shareholding is a significant component of a farmer's asset base equivalent to more than ten percent of the real estate value. For this reason it is important to explain how shareholding is currently structured and to consider how this could change in a deregulated environment with a mega co-operative. Under the Co-operatives Companies Act 1996 and the Companies Act 1993, dairy companies were required to create a comprehensive constitution. The constitution of Kiwi Co-operative Dairies Ltd provides for 12 classes of ordinary shares. The table below illustrates the current status of these share classes.

Class 1	Supplier shares, related to production, carry a right to bonus issue
Class 2,3 & 4	Allowed for increase in share standard from 1997 to 2000
Class 5 – 10	Not currently defined, provide flexibility to raise new equity
Class 11	Reserve shares, owned in excess to current production
Class 12	Dry shares, owned by suppliers who have ceased production

**Table 2. Kiwi Co-op Dairies Ltd share classes**

<sup>3</sup> [http://www.comcom.govt.nz/publications/display\\_mr.cfm?mr\\_id=578](http://www.comcom.govt.nz/publications/display_mr.cfm?mr_id=578)  
<http://www.comcom.govt.nz/adjudication/>

Under a mega co-operative, three categories of shares are proposed. The existing suppliers' shares will be retained with the range of classes that are currently in place. These shares reflect the value of the manufacturing infrastructure; factories, tankers, farm vats. Suppliers would receive a payment for milk supplied based on the commodity market. They would be required to own supplying shares equivalent to seasonal production.

Two additional share categories will be introduced, 'A' and 'Q' shares. The 'A' shares will represent returns from ingredient products, consumer products, the local market and non-dairy assets. An annual dividend will be paid on the class 'A' shares in relation to return from value added business. These shares will be linked to supply with ownership required to be within a range of 80 to 120 percent of current production. They are likely to be tradable between supplying shareholders in the first instance. The 'Q' shares represent returns from quota markets. The shares will be allocated based on supply at a specified point in time; they will be tradable and will pay a dividend reflecting the quota rent (phased in as rents are earned).

The cost of shares has increased significantly since 1995. In 1994/95 (prior to the Kiwi merger), shares in Tui Milk Products Ltd cost approximately 12 cents per kilogram milk solids (kg ms). In the 1995/96 season, existing suppliers who had increased supply continued to pay 12 cents per kg ms for supplying shares and new suppliers paid 69 cents per kg ms. In the 1997/98 season the value of Kiwi shares was bonused up to \$1.50 per kg ms, increasing to \$2.00 per kg ms by 1999/2000, as the value of the Dairy Board shares was passed on to suppliers. Under a mega co-operative there will be further increases in share costs. An estimation of the cost of shares based on the value of off-farm assets shows that the value of the manufacturing business equates to approximately \$2 per kg ms and the value of the marketing business is within the range of \$5 to \$7 per kg ms.

### **IMPLICATIONS OF CHANGE FOR FARMERS**

There are several threats to farmers produced by the restructuring. Prior to 1995 shares had a nominal value accounting for less than one percent of the value of the farm investment. With the recent changes in share standard they are now worth approximately ten percent of the value of the investment and with the proposed changes this is likely to increase to over 40 percent. The table below illustrates the changing structure of the farm investment in a non-inflationary environment.

<b>Year</b>	<b>1994</b>	<b>2000</b>	<b>2002</b>
<b>Value of improvements</b>	\$350,000	\$350,000	\$350,000
<b>Land value</b>	\$1,338,000	\$1,150,000	\$650,000
<b>Current market value</b>	\$1,688,000	\$1,500,000	\$1,000,000
<b>Share value</b>	\$12,000	\$200,000	\$700,000
<b>Total asset value</b>	\$1,700,000	\$1,700,000	\$1,700,000

**Table 3. Value of dairy farm assets**

The bundle of assets has remained the same but the makeup of the bundle is markedly different. One important aspect of the difference is that financial institutions are not

able to take security over dairy company shareholding and farmers will find that their available security has been eroded. The above table shows a 40 percent reduction in available security from 1994 to 2002. Farmers with a high debt to equity ratio in 2000 would have insufficient security to be bankable if share values increase in 2002. This issue must be addressed by the financial institutions in consultation with the dairy companies.

The bundle of assets must be considered carefully by farm purchasers. In the past, size of the land holding was the most important issue. Now a purchaser will need to take careful account of the size of the shareholding as well. If production levels increase, additional shareholding will need to be purchased and this cost could be significant (a 10,000 kg increase production could cost \$70,000). The makeup of shareholding purchased is also of importance. There is likely to be a cost to transfer shares from reserve to supply (shares that went into reserve at \$2 may cost \$5 to convert to supplying shares).

The table above illustrates the impact that the change in structure could have on the value of dairy farm land showing a possible 50 percent fall in the value of land. This will flow on to the value of land that is suitable for dairy conversion. It is most likely that this class of land will reduce in value. But the scale of the reduction will depend on the returns achievable from alternative land uses and the demand for alternative land uses. In localities where lifestyle use or horticultural production underpins the market, land values may not fall at all.

Payout calculations will become more complex with the change in company structure. Payout will include a payment for supply based on the commodity price achieved for that season, a dividend on 'A' shares based on returns for value added product, and a return on 'Q' shares owned from the quota market. Historically, the Dairy Board has been able to provide farmers with indications of payout levels prior to the start of a season. These indications have been reasonably accurate. With the change in structure, price signals prior to the start of a season will be more difficult to make.

Share requirements will become more complex and farmers will need to be very aware of the impact of increasing production. An additional 5,000 kilograms of production could cost \$35,000 the following season. This payment would be deducted from dairy company payments to a farmer with no price spreading options available. For this reason, farmers will need to consider more carefully the cost of increasing production and look at alternative resource uses to make the best financial decisions.

Information on shares sold with a dairy farm (price, class and number) will be an important requirement in the valuation of dairy farms. However access to accurate data may be difficult to obtain. Publicly available information includes a price paid for the real estate and a price paid for 'other' assets included in the transaction. A breakdown of other items is not available and what information is available is often inaccurate.

## **CONCLUSION**

As the New Zealand dairy industry works towards a revised structure it appears that the drive for power amongst industry leaders may take priority over profit for the farmer shareholders. Industry leaders and political leaders have shown strong support for deregulation of the New Zealand dairy industry and formation of a mega co-operative; they quote estimates presented in recent industry studies of 15 percent compound growth in industry earnings achievable with the revised structure. The farmer owners of the industry have only had access to brief details of these studies and have not been told how growth will be attained. However the Commerce Commission has fully investigated the industry studies and does not accept industry estimates; they report gains are possible without a mega merger and detriments need to be assessed. Even with an increase in earnings, benefits are unlikely to flow down to the supplying shareholders. Since 1997, Dairy Board turnover has increased while the payout to farmers has decreased. It is not obvious why the changed structure will alter this pattern. The supplying shareholders carry the investment risk and should receive the rewards of increased earnings.

Funding growth is a continuing industry issue with large amounts of capital required to develop value-added markets. Introduction of outside equity would be possible after deregulation and is seen by some as a threat to the farmer owners. While there is no declared intention to bring in outside equity, and industry leaders reassure farmer shareholders that this will be their decision, the corporate structure with revised share standards leaves this as a future option. If this occurs the pressure will be there for the industry to pay a return to investors at the expense of the return paid for the primary product.

Revision of dairy company shareholding has been one of the most significant changes for dairy farmers. The increase in share standards has allowed definition of the ownership of the industry's off-farm assets and removal of the value of the off-farm assets from land value. It also provides an indication of the cost of processing and marketing additional milk and gives the industry capital to process additional supply. These are worthwhile changes bringing greater transparency to the industry. However farmers need to be aware of the implications of these changes for their business.

The dairy industry in New Zealand is farmer owned and any change that is introduced should benefit the farmers as owners of the industry. A mega co-operative operating in a deregulated environment may not achieve this. It may only satisfy the egos of those in positions of power, and generate wealth off shore where new marketing business is established.