Rural Report
Economics
March 2009

A financial commentary on New Zealand rural co-operatives

The New Zealand rural co-operatives studied in this paper make up five of the top 20 and eight of the top 30 companies in New Zealand by turnover. The objective of this research was to see if there was any appreciable difference in the financial performance and position of the rural co-operative companies.

We found that many of the financial efficiency performance indicators of these co-operatives are similar within a functional category as one might expect. There are material differences in the levels of equity, capital structures and redemption risk.

Payment to and prices paid to farmer shareholders are often blurred by non-market income or expenses.

An ongoing due diligence on major purchasers or suppliers of the farm business should be part of the risk management plan of every farmer.

Preamble

The companies fall into four natural groups:

- dairy (Fonterra, Westland and Tatua);
- meat processors (Silver Fern Farms and Alliance);
- fertiliser manufacturers (Ballance and Ravensdown); and
- merchandise co-operatives supplying farm inputs and services (Combined Rural Traders and Farmlands).

Measures

Several of the financial performance indicators that might help meet the objective of this paper were not available. To be fair, they are not available for listed or privately owned companies either.

Direct financial comparisons between companies are always a challange. The underlying trends in the data can be more important than the absolute numbers. This article focuses on eight high-level measures including absolute values and trends in:

- growth in gross income;
- gross margins;
- capital turnover;
- rebates;
- the amount retained for the future;
- the amount of shareholder capital;
- the redemption risk and
- the amount paid for produce or charged for input.

Cash flows are important and the basis of calculation under IFRS standards has changed. Dedicated students should read Alan J Robb's article in the December 2008 issue of *The Dairy Exporter*, page 8, for more detail.

One can also keep drilling down into day's stock turn, day's sundry debtors, cover of money owed to shareholders; etc. They are important but it does become information overload. The time period of trend analyses is important. Too short and volatility can distort the trends; too long and the business model can change. Four years is an unusual period but it was best fit for valid comparisons in this instance.

Methodology

The data was restated in a near common format.

The data was obtained from publicly available information (annual reports or financial statements 2006 to 2008) and used without any adjustments. The comparisons use the new International Financial Reporting (IFRS) standards for the financial year ending 2007 and 2008. The new standards increase the level of detail available.

Adoption of IFRS created some one-off adjustments for 2007. The standard also creates ongoing accounting adjustments in 2008 and subsequent years. The IFRS requires presentation of unrealised gains/losses (e.g. from hedging and other financial derivatives) into the statement of earnings (profit and loss for the older reader). Such entries can be significant. The merchandise co-operatives are least affected as they make less use of complex financial instruments.

A perspective of scale

Fonterra is a stand out in terms of scale but the other co-operatives are also large businesses.

Table 1
SALES
($m)

FINANCIAL YEAR END	2005	2006	2007	2008
Fonterra	11,583	12,807	13,687	19,512
Westland	210	237	295	501
Tatua	111	134	145	195
SFF	2,030	2,028	1,829	1,963
Alliance	1,094	1,083	1,116	1,294
Ballance	458	471	497	652
Ravensdown	494	469	497	673
CRT	389	431	479	577
Farmlands	305	334	361	444

Notes

SSF is Silver Fern Farms

CRT is Combined Rural Traders

The balance dates are consistent within categories but not between categories. CRT balances 31 March and Farmlands 30 June.

Growth in sales

There are some mixed results here. Growth in sales for processors and manufacturers can be highly dependent on growth in volume, which in turn is often subject to significant within and between year variations in supply.

The dollar amount of sales is a function of product mix, volume sold, the price obtained and changes in inventory. The dairy and fertiliser industry do declare volume figures but meat processors don't. Inventory changes have been significant at times in all three groups.

Increases in price rather than volume provided a huge boost to sales for dairy companies in 2008. Meat processors gained volume from a reduction in sheep and deer numbers. Fertiliser and merchandise sales in 2008 were boosted by increased revenue from the dairy sector.

Table 2

PERCENTAGE CHANGE IN SALES

FINANCIAL YEAR END	2005	2006	2007	2008
Fonterra	9	11	8	43
Westland	-1	13	21	70
Tatua	9	22	8	28
SFF	-8	NC	-9	7
Alliance	-3	-3	5	15
Ballance	NA	3	7	31
Ravensdown	11	-5	6	35
CRT	NA	11	11	21
Farmlands	NA	9	8	23

Gross margin percentage

Gross margins are similar within a category. The exceptions are Westland and Ravensdown.

The size of the gross margin is a function of sales revenue and the unit cost of sale. A higher GM can be a result of more favourable sales, lower costs or a combination of both. Changes in inventory levels may also be an influence. Costs include depreciation but not interest or tax. Revenue excludes 'other' revenue.

But there is insufficient data available to comment in more detail. Ideally the cost and weight of livestock or raw material purchased would be separated out from a broad breakdown of other costs. Companies in many industries do not do this as they are not required to disclose the information and/or it is claimed to be commercially sensitive.

The gross margin (GM) shows if there are any real differences in alternative business models. It is clearest in the dairy sector where the GM is before payment for milk. The high percentage gross margin of Westland reflects a simple business model of low cost and selling dairy commodities.

The GM for the remaining categories is calculated after the first-time payment for goods or services but before rebates or bonuses.

The GMs in the meat industry are always small. The fertiliser sector comes closest to having the GM untangled but even that has clouded revenue with diversification into fertiliser spreading. Ravensdown has also diversified into merchandising. It appears that Ravensdown operates on a lower GM than Ballance.

The two merchandise suppliers have very similar GMs.

Table 3

GROSS MARGIN

(Percent)

FINANCIAL YEAR END	2005	2006	2007	2008
Fonterra	43	44	45	47
Westland	67	69	66	66
Tatua	40	40	40	45
SFF	2	2	-1	4
Alliance	2	5	2	6
Ballance	NA	9	9	11
Ravensdown	7	5	5	6
CRT	NA	5	5	6
Farmlands	NA	6	6	7

Capital turnover

Capital turnover ratios (CTRs) are also similar within a category.

The ratio shows how many dollars of revenue are generated per dollar invested. It is one indicator showing how efficient the investment is. The capital turnover was calculated by dividing gross sales by total assets.

The jump in the CTRs of dairy companies in 2008 has more to do with a sharp price increase per unit sold than any improved efficiency in the use of capital, although that may also be a contributing factor. Ravensdown's lower ratio for 2008 is influenced by a large increase in the volume and/or value of inventory on hand at balance date.

The merchandise companies have a low investment in fixed assets and inventory relative to turnover and one would expect a higher CTO ratio from these businesses.

Table 4

CAPITAL TURNOVER RATIOS

($ Sales /Total $ Invested)

FINANCIAL YEAR END	2005	2006	2007	2008
Fonterra	1.0	1.0	1.0	1.4
Westland	1.0	0.9	0.9	1.5
Tatua	1.1	1.1	1.3	1.4
SFF	2.7	2.7	2.8	2.9
Alliance	2.8	2.5	2.4	2.6
Ballance	1.3	1.3	1.2	1.4
Ravensdown	1.1	1.2	1.3	1.1
CRT	5.2	5.2	5.2	5.1
Farmlands	5.6	5.4	5.2	4.8

Rebates

There is insufficient information to compare rebates within categories.

The level of rebate paid is a function of the gross margin and the need to retain capital.

It has already been noted that dissecting the GM is not possible and that observation cascades to analysing the proportion of revenue paid as rebates.

Table 5

REBATES

(Percent operational surplus)

FINANCIAL YEAR END	2005	2006	2007	2008
SFF	1	1	Nil	1
Alliance	1	2	1	2
Ballance	NA	4	4	6
Ravensdown	4	2	3	2
CRT	NA	4	3	4
Farmlands	NA	5	6	6

Note: Operational Surplus is defined as sales plus closing inventory less opening inventory.

The dairy sector does not split the payment of milk into a payment for milk and a bonus per se. Fonterra is on its fourth variation of trying to get to a milk price and a value-add return but the transparency of the calculations is lacking. The other companies declare an all-encompassing milk price.

The meat and merchandise groups pay very similar percentage rebates within the group and the lower gross margin of Ravensdown transposes into a lower percentage rebate. The farm gate price for comparable fertiliser is generally very similar. Does Ravensdown have a higher cost structure?

Retained profits

The co-operatives retained little capital for future growth.

Companies need to retain capital if they are to grow (just as banks need to!). Payout and rebates cannot be supported from reserves for ever but can be used to smooth such payments if equity and liquidity are sound.

All the co-operatives have not been good at retaining capital. Arguably the need to do so has been low for expanding processing co-operatives where the shareholder must hold shares in proportion to the use made of the co-operative. Growth funds growth in these instances. There are some provisos. The capital contribution from the shareholder has to be sufficient to fund the growth of the co-operative. A higher level of retained profit is required when the entry fee to the co-operative is a flat, one-off sum (e.g. the merchandise co-operatives). The second proviso is the balance sheet has to be strong enough to provide for normal business risk.

Dairy companies have been most active in using reserves to support payout with Westland the most dynamic.

SFF had a loss and restructuring provisions that dented retentions in 2006 and 2007. Ravensdown also had a negative transfer to reserves in 2007, in part due to a negative $30m IFRS adjustment.

Table 6

GROSS REVENUE RETAINED

(Percent operational surplus)

FINANCIAL YEAR END	2005	2006	2007	2008
Fonterra	2	+	2	-2
Westland	(-)	+	2	-2
Tatua	+	-1	+	2
SFF	+	1	-4	2
Alliance	+	2	+	2
Ballance	NA	2	5	3
Ravensdown	1	+	-6	3
CRT	NA	+	+	+
Farmlands	NA	1	(-)	(-)

Note: + or (-) means amount retained is in the range of -0.9 to + 0.9 percent of gross sales.

Equity

There is more divergence within categories with regard to the trend and proportion of shareholder funds invested in the business.

The proportion and value of equity should reflect the overall business risk as equity can provide a buffer against unfavourable business conditions. Of course different people (directors/management) have different perceptions about risk even within the same business category. This last point is well illustrated in table 7.

Table 7

EQUITY PERCENT

FINANCIAL YEAR END	2005	2006	2007	2008
Fonterra	40	38	36	29
Westland	70	58	59	55
Tatua	52	43	56	52
SFF	34	37	35	41
Alliance	71	69	69	69
Ballance	65	66	63	64
Ravensdown	56	69	59	41
CRT	3	33	33	31
Farmlands	52	50	51	40

Fonterra has a lower equity percentage than the other two dairy co-operatives, increasingly so in the past four years. The percentage equity for Westland and Tatua is sound but Fonterra at 29 percent is below an accepted minimum corporate manufacturing business norm of around 40 percent.

Fonterra's year end 2008 figure does include a net $600m withdrawal of equity by share redemptions.

While that may have met favour with the shareholders involved, was it a good business decision?

Similarly SFF runs a more aggressive balance sheet than Alliance and is still digesting the take over of Richmond. Alliance still recalls the financial difficulty it got into during the 1990s and runs a much stronger balance sheet.

The reduction in Ravensdown and Farmlands' equity at 2008 reflects the acquisition of business with debt and a low amount of profit retained in that year.

Redemption risk

There is considerable variation in the redemption risk both within and between the four categories of co-operatives.

The entry fee into a traditional co-operative is usually a specified parcel of shares at a set (par) value. The shares are paid back (redeemed) by the co-operative at the par value when the shareholder wants to leave the co-operative. The risk for the co-operative is that more shareholders leave than want to join, or worse, there is a 'run' on redemptions.

A simplistic measure of the initial risk is to express the paid up share capital as a percentage of total shareholder funds (paid up capital plus retained profits). The smaller the percentage of paid up capital, the greater buffer a co-operative might have against redemption risk.

The simplistic measure suggests that the redemption risk for Fonterra is very high; Ballance, Ravensdown and CRT moderately high; and the remainder low.

Table 8

REDEMPTION RISK

(Dollars Redeemable as Percentage of Shareholder Funds)

FINANCIAL YEAR END	2005	2006	2007	2008
Fonterra	146	147	179	158
Westland	38	39	36	38
Tatua	56	56	48	41
SFF	20	27	28	27
Alliance	17	20	19	17
Ballance	80	79	83	74
Ravensdown	75	80	91	86
CRT	92	91	92	86
Farmlands	48	51	44	48

The redemption risk is reduced, in practice, by policies including setting out the notice required before redemption and the subsequent timing of redemption payments. These are often spread out over one or more years. The co-operative constitution usually allows directors to change the redemption policy if the stability of the co-operative is threatened by an undue level of redemptions. Maintaining a strong equity position and ensuring the total dollars redeemable are a small proportion of total shareholder funds are additional redemption risk management strategies.

Redemption risk is not an issue faced by listed companies. The shareholder acquires shares at a float or buys on the stock exchange. The shares are sold at the market price to another purchaser, again through the stock exchange, when the shareholder wants to exit the company.

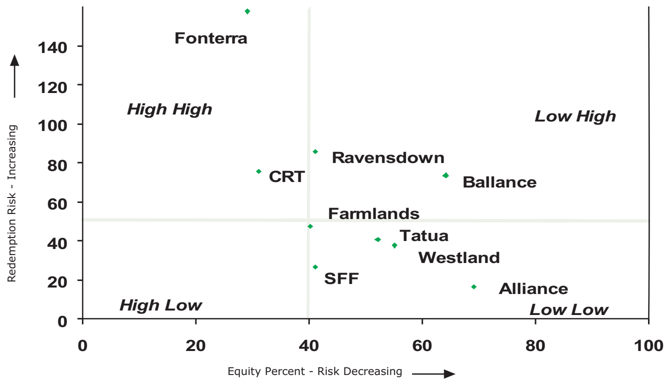
Redemption risk and equity

Tying equity and redemption risk together suggests that co-operatives with a higher redemption risk should have higher equity, but do they?

The matrix shows the relative positioning of the subject co-operatives at balance date 2008.

The words in italics are a general indication of the relative risk ranking for each quadrant starting with the equity position and then the redemption risk. Thus the *High Low* quadrant has a high equity risk and a low redemption risk. The risk increases as a co-operative moves from the bottom right hand corner to the top left.

Figure 1



The previous suggested rating of the redemption risk for Fonterra is unchanged from the earlier discussion. The redemption risk of Ravensdown and CRT might be considered to be unchanged at moderately high. Ballance has high equity offsetting its redemption risk.

The remainder of the co-operatives retain a low redemption risk rating. There has been little change in the relative position for most of the co-operatives in the quadrants over the four-year period studied. Ravensdown has moved to a relatively higher risk position in 2008 with the decline in equity. Fonterra has always been in the same quadrant but moved higher.

The placement of the dividing lines in the matrix is a subjective judgement by the writer. Forty percent equity is a commonly accepted minimum equity as previously mentioned. Having redeemable capital less than 50 percent of total shareholders would seem a prudent benchmark. No doubt some would argue for other parameters.

Other considerations for redemption risk

Other considerations of redemption risk include the dependence by the shareholder on the co-operative, and the size of their investment.

The dynamics here are intriguing. We could write at length about the different capital structures of the co-operatives both within and between groups but will confine the discussion to considering the dependence and investment of the shareholder.

Dairy farmers have a very high reliance on the co-operative dairy company to process milk within a season. But competition from new emerging companies, technology and modern transport is slowly providing dairy farmers with more choice as to which company they might supply. Tatua shareholders are spoilt for choice. The dairy shareholder investment is high relative to the other categories of co-operatives. In contrast, all dairy companies have a very high dependence on the shareholders maintaining supply!

The meat processors do not have fully committed suppliers because the suppliers have ready access to alternative publicly or privately owned processors. They can also sell livestock to another farmer. The investment per shareholder is modest. Fertiliser companies are similar to meat companies with farmers having a choice of supplier – especially as the companies have spread into each other's traditional geographic regions.

Table 9

DEPENDENCY AND SHAREHOLDER INVESTMENT

Company	Dependency Of Shareholder*	Av Investment ($000)*
Fonterra	Very high but very slowly easing	612
Westland	High	170
Tatua	Low	230
SFF	Low	20
Alliance	Low	20
Ballance	Low	23
Ravensdown	Low	28
CRT	Very Low	0.2
Farmlands	Very Low	0.6

* NBNZ assessments/estimates

The merchandise co-operatives have large numbers of members with a very low investment and who also have a choice of alternative merchandise firms. The redemption risk might, in fact, be quite low as there are likely to be a significant number of low/no activity shareholders who disregard/forget about the nominal investment and leave it sitting for 'one day'.

There are a range of strategies used by co-operatives to retain members including bonus share issues, increasing the par value of the share, dividends on shares and loyalty programmes. The most visible strategy in the dairy industry is having the best payout!

Dairy payout

There is little to separate the three co-operatives on the basis of their average payout over time.

Differences in gross margins are generally smoothed by debt servicing, 'other' income and use of retention of profits or drawdown from reserves.

The first (and often only) focus of most dairy farmers and commentators is payout but that number gives a very narrow view of how well or otherwise a dairy co-operative is performing.

Disclosure of the price paid to shareholders for milk and the volume supplied is a feature of New Zealand dairy co-operatives. It is uncommon in dairy co-operatives. In other countries the disclosure is to be commended. Admittedly it is easy to do as milk is a homogeneous product; almost all supplied over the same time period and paid on a national average basis. That said, analysing the financial performance of a New Zealand dairy co-operative is still a challenge because of a 'bundled' payment to shareholders. The residual payment to shareholders has two components, milk supplied and capital. A cost can be attributed to capital to try and establish the 'market' price for milk.

The position is further complicated with profits (losses) obtained from activities not directly related to the sale of shareholder-supplied milk but included in the payment for milk.

As the proportion of sales (and costs) attributable to 'other' activities increases, the less that revenue and costs are directly related to the kilograms of milk solids (kg ms) supplied by shareholders. Dividing the monetary sums by kg ms supplied in these circumstances becomes less informative. Both Fonterra and Tatua have been in this situation for several years. Westland joined the group in the 2007/08 season by processing and selling milk from Synlait and buying an added-value business.

Similarly, trends in assets or liabilities per kg ms are distorted by seasonal variations in supply, e.g. the drought in 2007/08.

The term 'payout' has also become muddied. It has been used by Fonterra in particular in the past 12 months to mean the total available for payout before retention.

Payout in this paper is defined as the accrued sum booked in the financial statements attributed to payment to shareholders for milk supplied, i.e. after any retention by the company. It is the traditional definition expressed in cents per kilogram milk solids (c/kg ms).

Payout 2007/08

While Tatua regained the top of the ladder in 2007/08, longer-term averages for payout are very similar.

Table 10

PAYOUT YEAR END JULY 2008

(c/kg ms)

	Fonterra	Westland	Tatua
2007/08	769	796	800
Average			
3 Years	543	556	548
5 Years	502	503	503

Note: Figures are before the $0.03/kg ms industry good levy

Underlying performance

Fonterra and Tatua have a higher gross margin than Westland. The difference starts to narrow after Westland's low debt servicing is taken into account. The differences narrow further when the 'other' financial influences are considered. 'Other' includes foreign exchange gains/losses, other income, tax and now IFRS adjustments.

The range in net 'other' income over five years is estimated to sit between ($0.12) and $0.97/kg ms.

Table 11

GROSS MARGIN TO AVAILABLE FOR PAYOUT

(c/kg ms)

	Fonterra	Westland	Tatua
2007/08			
GM	798	749	798
Less Interest	(38)	(13)	(25)
Op Profit	**760**	**737**	**773**
Plus (Less)			
FX gain (loss)	1	46	97
Other Income	17	3	6
IFRS	(13)	(17)	(16)
Tax	6	4	(20)
Avail	**771**	**773**	**841**
Net 'Other' Average			
3 year	14	28	17
5 year	29	40	36

Actual paid

The amount paid does not always reflect the amount available. Transfer to (from) reserves also varies between companies and appears to be tactically as much as financially driven. The end result is that payouts are often very similar in any one year.

Not all co-operatives retained revenue in 2007/08. Tatua had a significantly higher residual available for payout in 2007/08 and chose to retain 41 cents. Fonterra, in spite of deducting 24 cents from payout, only managed to actually transfer 4 cents to shareholders' funds from business operations in 2007/08. Westland supported its payout by drawing 23 cents from reserves.

Table 12

AVAILABLE AND PAID

(c/kg ms)

	Fonterra	Westland	Tatua
2007/08			
Avail	771	773	841
Retained	(4)	23	(41)
Paid	**769**	**796**	**800**
Retained Average			
3 year	9	(1)	11
5 year	9	(3)	6

All three companies have been inconsistent with a retention policy. Westland has been the most active in using reserves to support payout as previously noted. In doing so, it has have maintained a neutral net transfer position and a strong balance sheet.

Observations

Co-operatives are often criticised as a business model but the frequency with which they appear in lists of top 20 or 30 companies in many countries suggests the model is not all bad. New Zealand rural co-operatives are no exception.

They have had their moments but have eventually prevailed. Several have a longevity that comfortably exceeds that of many other listed companies.

Are they more efficient than privately owned or listed rural companies? We have not completed the research to argue one way or the other. Other studies have pointed out that it is the standard of governance and management rather than structure that determines whether a business succeeds or fails.

There is well established competition in New Zealand both for meat processing and merchandising companies. That keeps both forms of ownership focused and pricing competitive. Privately owned competition is emerging in the dairy industry. They all perform at a similarly good (or poor?) basis in this situation and the mix of ownership keeps both categories honest.

Will co-operatives continue to be successful? Dairy and fertiliser companies have grown on expanding volumes of sales. Will that continue? Meat companies have faced a shrinking and changing ratio of sheep, cattle and deer for several years. They have rationalised and modernised on the way. A stable or falling livestock population is likely to involve more industry rationalisation. The strength of balance sheets will be important in this process.

Conclusions

Farmer-owned rural co-operatives are a significant part of New Zealand farming and the economy. While there are similarities in some financial performance indicators within groups of co-operatives, there are also some significant differences.

Is all this important?

Part of risk management for farmers should include ongoing due diligence on any major purchaser or supplier to their business. That includes farmer-owned co-operatives.

As an owner, you should understand key financial performance and financial position indicators to keep directors on their toes. Management may claim commercial sensitivity but it is your company. Questioning financial performance is a function undertaken by cornerstone investors in similar-sized listed companies, something co-operatives do not have. Similarly the shareholder should understand the share standard and redemption policies.

We also argue it is necessary that shareholders of the processing and manufacturing co-operatives understand that the price received or cost paid is often clouded by quite variable influences other than direct market returns or costs.

Shareholders making investment decisions for their own business should take into account the underlying market returns of produce and cost of inputs, and not just the face value numbers presented by the co-operative.

Dairy returns have been bolstered by averages of $0.15 to $0.40/kg ms by net 'other' income. At 1,000 kg ms per hectare that is $150 to $400 of annual income per hectare. At a five percent capitalisation rate this is the equivalent of $3,000 to $8,000/hectare that has been capitalised into the price of land. At two and a half percent the figures double, i.e. up to $16,000/hectare.

Yes the maths is broad brush but the principle is important. Can net 'other' income be relied on to that extent?

Finally, an appreciation of the contribution farmer-owned rural co-operatives make to the New Zealand economy is useful in reinforcing the importance of farming to this country.

Acknowledgements

Thank you to the co-operatives for making their annual reports available.

Kevin Wilson (“Investment Adviser”)

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