4. The performance of Australian food companies

THE PERFORMANCE OF AUSTRALIAN DAIRY COMPANIES

Company performance analysis

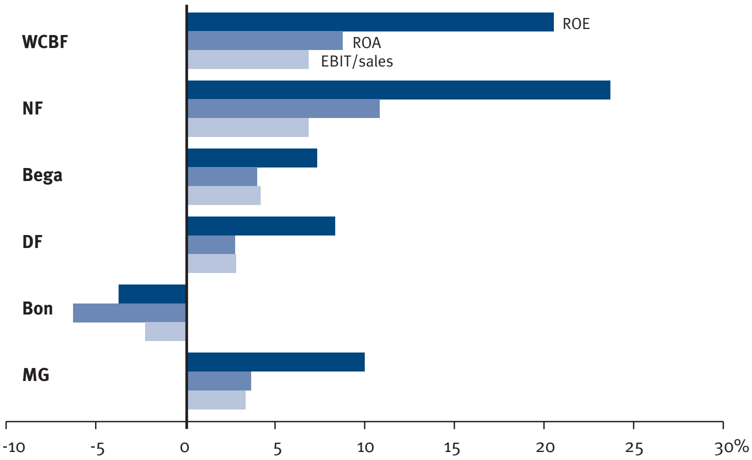
We have set out a comparison of the recent historical performance of dairy companies in the Australian industry that are engaged in the cheddar cheese manufacturing and marketing business.

There are a number of dairy companies engaged in processing and manufacturing in the Australian industry. The majority of these enterprises, with the exception of National Foods, are cooperatives.

The summary indicators give a limited appreciation of the relative performance of these companies in the cheese category for the following reasons:

- the majority of companies that are involved in the dairy sector are cooperatives;
- cooperatives typically structure their affairs such that milk payments to suppliers are a balancing item after withholding an appropriate amount for capital improvements, working capital and unforeseen fluctuations in returns;
- whilst the resulting value of milk is closely related to movements in international prices, as noted earlier in this report, the net value from world market returns effectively sets prices for suppliers to the domestic market;
- dairy companies operate either:
  - across the spectrum of dairy commodities (Bonlac, Murray Goulburn)
  - with a focus on consumer branded products (National Foods); or
  - with exposure to both (Dairy Farmers); and
- the company with the greatest degree of specialisation in cheese production is Bega Cheese, which owns a small cheese plant and a major cut-and-wrap facility.

Figure 114. **Returns of Australian dairy companies, three-year average**



Source: Whitehall Associates' analysis of financial statements

Abbreviations

WCBF	Warrnambool Cheese and Butter Factory Ltd (in Victoria)
NF	National Foods
DF	Dairy Farmers
Bon	Bonlac
MG	Murray Goulburn
ROE	return on equity capital employed
ROA	return on assets
EBIT	earnings before interest and tax
SHF	shareholders' funds

- There is a strong contrast in the return profile between cooperatives and public companies (National Foods and the unlisted WCBF). National provides the best returns on assets and on invested equity capital of those selected and has limited commodity manufacturing.
- Bonlac Foods lost money in 2002 and 2000 when it hit difficulties in exposure to currency movements and had poor overhead recoveries from declining milk volumes. The effects of an attempt to a dual strategy of commodity manufacturing and brand management left the business with shortages of capital and an inability to compete for milk supplies with other Victorian manufacturers.

Financial position of dairy companies

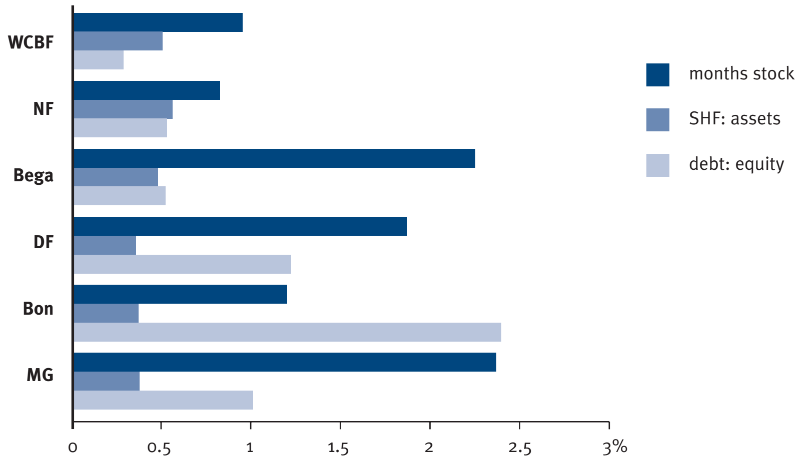
We have set out a comparison of the recent historical financial position of dairy companies in the Australian industry, in terms of:

- the turnover of inventory (latest reported in 2002), expressed as months of stock on hand;
- the ratio of shareholders' funds to total assets; and
- gearing (the ratio of debt:equity).

A variety of situations can be explained by the different strategic positions taken by the Australian companies and/or the way in which they have responded to changes in the industry.

- Dairy Farmers and Murray Goulburn have followed the traditional cooperative model in funding their businesses, operating at or above a debt:equity ratio of 1.0.
- Cooperatives such as Murray Goulburn, Dairy Farmers and Bonlac raise capital through deductions from the gross milk returns paid to their members, though members are allowed to increase share investments at any time.
- Bega operates as a traditional cooperative but has restructured in 2001 using the proceeds of a sale of its brand licences to reduce its overall debt levels and reduce the exposure of its business to cheese manufacturing.
- Bonlac Foods has, since 2000, operated a hybrid corporate structure to accommodate the investment in the Bonlac business by Fonterra. It retains high debt levels in this comparison – since reduced through the further acquisition of shares by Fonterra. Bonlac's financial position worsened in the late 1990s due to currency exposure and heavy investments in branded consumer goods businesses.

Figure 115. **Financial position of Australian dairy companies**



Source: Whitehall Associates' analysis of financial statements

- National Foods has operated with low levels of debt, given its good cash flows and recent focus on being the lowest cost milk processor in the domestic industry.
- Different companies have adjusted very differently to deregulation of the industry.

THE PERFORMANCE OF AUSTRALIAN VERSUS WORLD DAIRY COMPANIES

Profitability

We have compared the best in class from the Australian information (mostly based on the results of National Foods) with a number of dairy companies from the world dairy industry. These companies include:

Glanbia (Glan) – an Irish-based cheese and dairy ingredients group;

Friesland Coberco (FC) – a major Dutch cooperative;

Saputo (Sap) – a listed Canadian cheese maker;

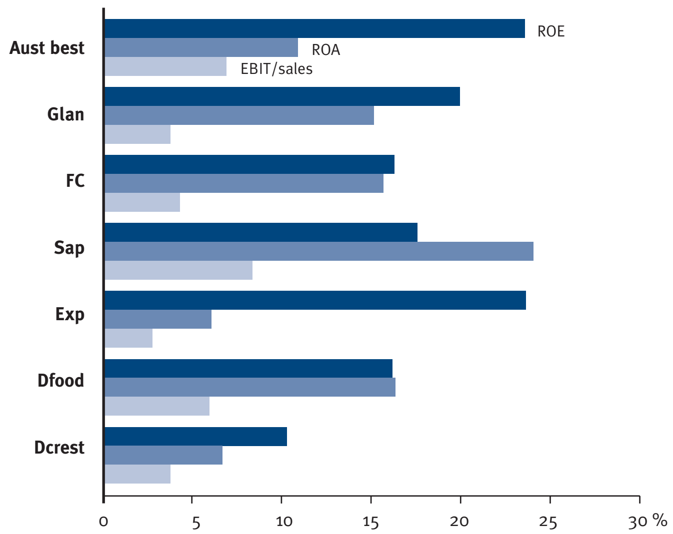
Express Dairies (Exp) – a listed United Kingdom milk processor;

Dean Foods (Dfood) – a listed major United States processor and manufacturer;

Dairy Crest (Dcrest) – a leading United Kingdom milk processor and cheese business.

In this analysis, Australian dairy companies performed well against these international companies in terms of margins and return on assets. Australia's best of class compare favourably with listed dairy companies from North America and the United Kingdom.

Figure 116. **Returns of dairy companies, three-year average**



Financial structure

The combined financial position of the Australian dairy cooperative sector has been compared to the major cooperatives in the global dairy industry.

Arla – a major Scandinavian cooperative;

Friesland Coberco – a major Dutch cooperative;

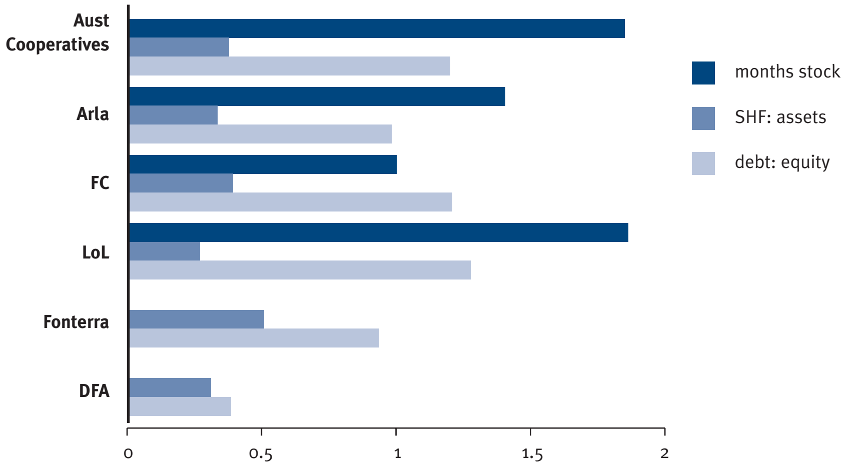
Land o Lakes (LoL) – a large United States cooperative;

Fonterra – the major New Zealand manufacturer/exporter;

Dairy Farmers of America (DFA) – the largest cooperative in the United States and the world.

Again the financial structures of the Australian sector are not significantly different from those of the overseas cooperatives, yet there are major differences in the nature of the businesses covered in this sample. The management by cooperatives of their cash flows, financial position and supplier payments is broadly similar. Northern European cooperatives are engaged in brand management as well as commodity manufacture, whereas United States cooperatives are primarily engaged in manufacturing.

Figure 117. **Financial position of dairy companies**



Source: Whitehall Associates' analysis of financial statements

BRAND MANAGERS IN THE GROCERY FOOD INDUSTRY

Foreign domination of brands

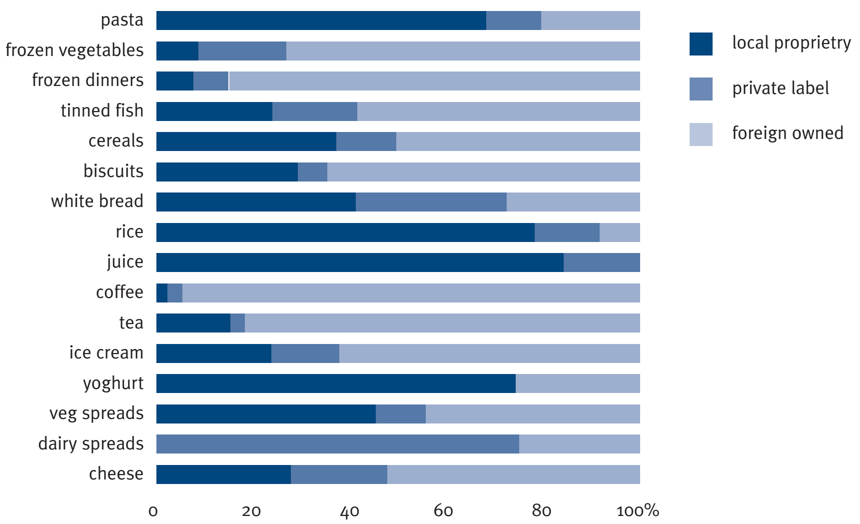
We have set out in the chart below a comparison of the ownership of brands in major branded grocery food categories in the retail sector. Many categories in the grocery sector are now dominated by a limited number of foreign-owned multinationals and local dominance is restricted to those which are based on fresh food industries (some categories of dairy, citrus, bread) and aspects of grains and oilseed products (pasta, spreads).

The analysis below retains Goodman Fielder as a local public company, even though it recently passed into the control of a New Zealand-based group.

An evaluation of the performance of Australian food companies based on reported financial information is therefore somewhat difficult, as this requires reliance on:

- the publicly reported results of the few large listed Australian food companies which remain independent;
- a review of documents lodged by Australian subsidiaries of multinational food groups with significant local interests; and
- a review of the reported results of global food groups with significant operations in the Australian food industry.

Figure 118. **Control of brands, share by value, 2002**



Source: Foodweek 2003

THE PERFORMANCE OF GLOBAL BRAND MANAGERS

The major players

We have extracted a comparison of the recent performance (over the past two full financial years) of major multinational food companies.

In recent years these global players have shifted more of their emphasis towards brand management than food manufacturing, preferring strong alliances with suppliers of ingredients or finished products to heavy ongoing investments in plant and other fixed assets. These tend to perform less favourably as investments compared with investments in brand equity.

Hence there is evidence of businesses with dominant brand positions in most markets in which they operate providing strong cash flow, high balance sheet gearing (the ratio of debt to equity) and a high proportion of investment in intangible assets including goodwill in acquired businesses. Goodwill is required to be carried on the books according to global accounting laws.

Each of these groups is now firmly locked into strategies which take advantage of global sourcing of inputs to reduce exposure to the high-cost operating environments in their countries of origin.

Reported growth rates of the major food groups loses meaning due to the extent of their geographic spread and the fluctuating influence of currency on their home-reported results.

Figure 119. **Returns of global food companies, two-year average**

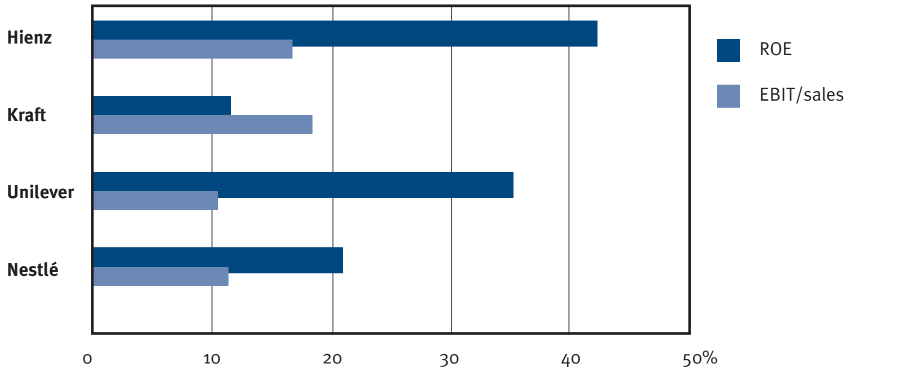
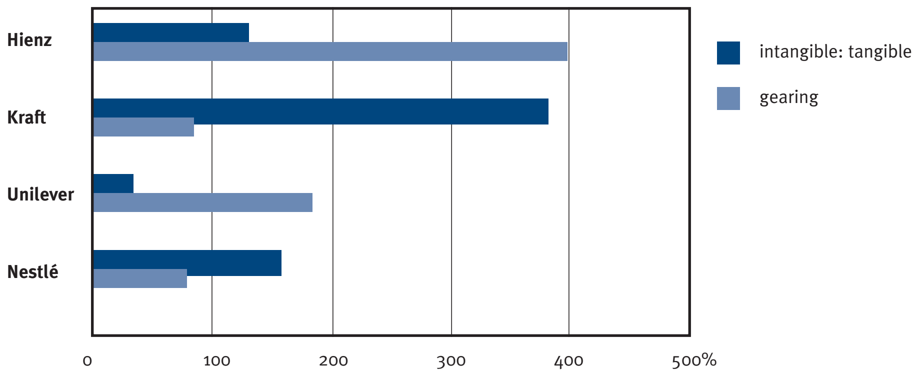


Figure 120. **Balance sheets of global food companies, %**



Source: Whitehall Associates' analysis of financial statements

THE PERFORMANCE OF AUSTRALIAN BRAND MANAGERS

Comparison

We have compared the reported performance of listed and other major Australian brand managers with the ratios of the major players in terms of margins and overall returns on equity capital.

In this analysis, comparisons are made with:

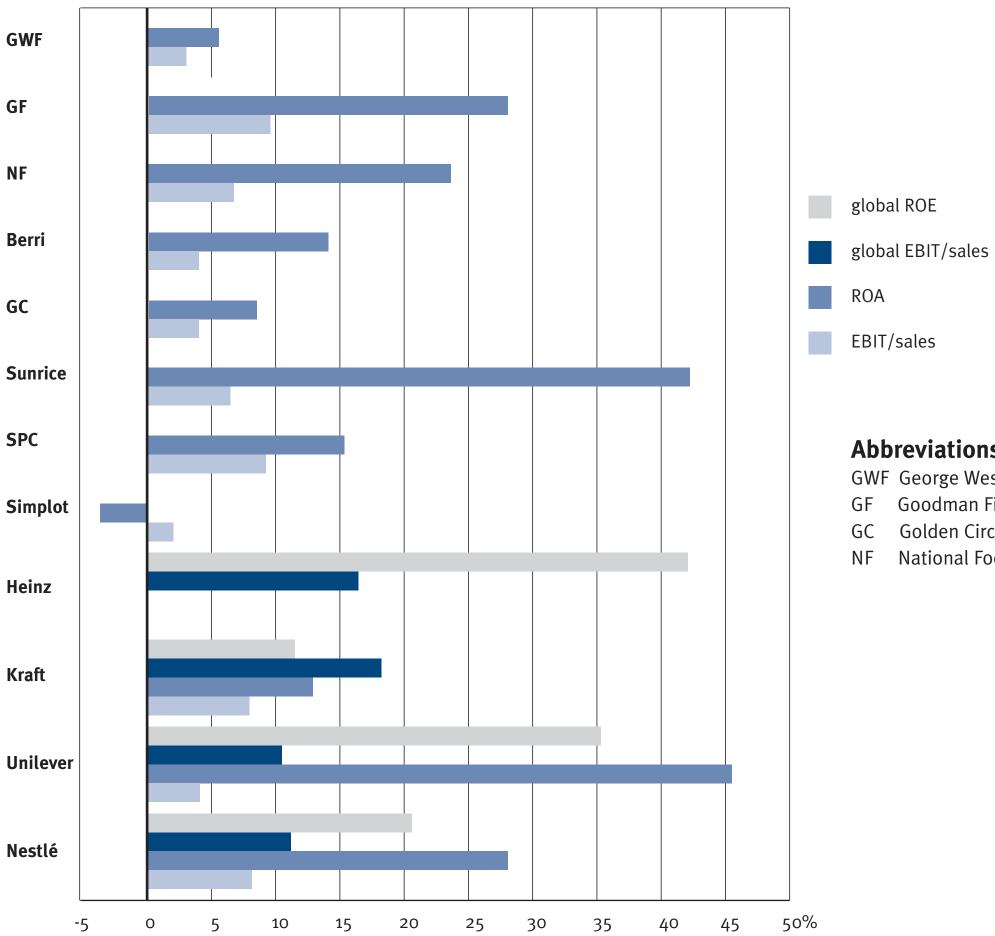
- the stated global margins of the major multinational food companies; and
- the reported margins made in the Australian-based subsidiaries of global brand managers.

Australian data on global companies has been taken from the most recently available IBIS reported information and Australian Securities and Investments Commission search results.

In this analysis:

- although the diverse businesses that are based in the Australian industry have an exposure to different market segments from global counterparts, the earnings before interest and tax of Australian companies are not significantly out of step with the returns their foreign counterparts earn within the Australian food industry;
- earnings before interest and tax in this industry on average are lower than the levels that multinationals can earn in total in their business;
- returns on equity capital employed are generally lower than those seen in the global context. This has much to do with the mix of capital investments made by global players; and
- Australian companies listed in this comparison have a greater involvement in primary manufacturing alongside management of their brands compared to the mix of on-balance sheet investment focus of the global majors. The Australian companies do not have the critical mass of market in the Australian food industry to adopt the brand investment and acquisition strategies followed by the larger companies.

Figure 121. **Returns of global and Australian food companies, two-year average**



Abbreviations

GWF George Weston Foods
GF Goodman Fielder
GC Golden Circle
NF National Foods

Source: Whitehall Associates' analysis of financial statements

THE PERFORMANCE OF PRIMARY MANUFACTURERS/CONVERTERS

Comparison

We have also compared the reported performances of a number of primary manufacturing businesses and industries.

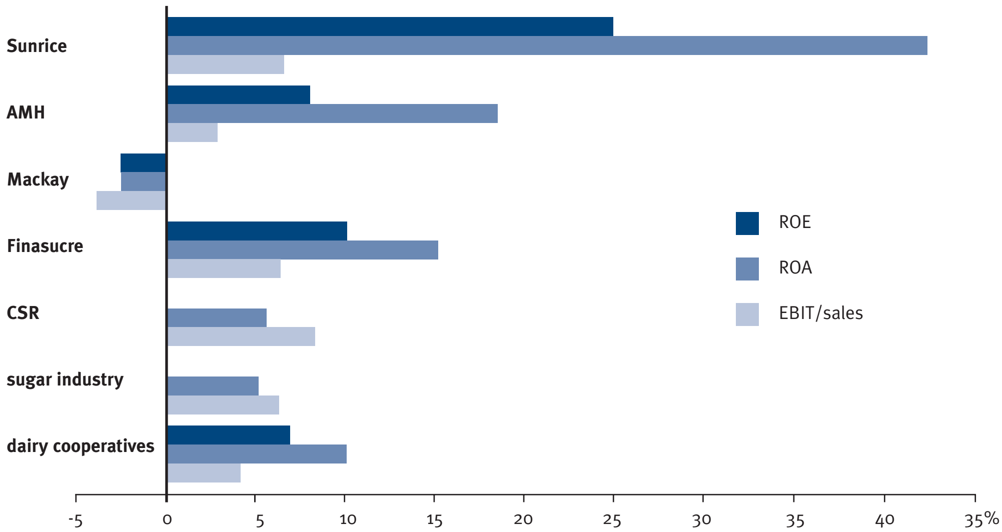
In this analysis a comparison is made between:

- **rice** – providing the analysis of Sunrice (Ricegrowers Cooperative);
- **meat** – showing the reported performance of Australia Meat Holdings (AMH);
- **sugar** – showing each of the major sugar companies (Mackay, Finasucre and CSR), as well as an industry average; and
- **dairy** – showing the aggregate performance of the major dairy cooperatives.

In this analysis:

- The primary driver of returns in each of these sectors is the export market, which dominates the end markets for each of these commodity groups.
- Comparatively low equity and asset returns are being earned in the sugar and dairy sectors due to low world prices in the period of this analysis.
- While the major meat processor has low earnings before interest and tax, it is on a high throughput and the business (Australia's largest meat processor) earns a higher return on equity compared with others.
- The major rice processor and marketer earns a high return on equity and assets compared to other sectors. This has been due to a rationalisation of industry assets in recent years which has improved the cost-competitiveness of the industry's value chain.

Figure 122. **Returns for primary manufacturers, three-year average**



Source: Whitehall Associates' analysis of financial statements