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THE CHALLENGE OF AGRICULTURAL CO-OPERATIVES
INTERNATIONALISATION:
CASE STUDIES OF FONTERRA AND ZESPRI

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ABSTRACT

Internationalisation of agricultural co-operatives is a worldwide trend that has been identified by several studies as one of the key challenges co-operatives are currently facing. The main question that this paper aims to answer is: how can agricultural co-operatives internationalise without generating conflicts with or distancing themselves from their members? Starting with a comprehensive literature review of the internationalisation of agricultural co-operatives globally, the paper introduces a new descriptive model for determining internationalisation of co-operatives. Using the mentioned model, the paper develops in detail the case studies of two New Zealand co-operatives: Fonterra, a pure co-operative in the dairy industry and Zespri, a co-operative hybrid in the kiwifruit industry, and their internationalisation situation. Based on a cross-case comparison the paper finally outlines the risks, potential conflicts and critical factors these two co-operatives face in their internationalisation process.

Keywords: agricultural co-operatives, internationalisation, international business, agribusiness, dairy industry, kiwifruit, Fonterra, Zespri.

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CHAPTER ONE: INTRODUCTION

1.1 Background

With the continued liberalization of trade, farmers, growers and food producers in general are being faced with new opportunities and challenges in relation to internationalisation. This applies to co-operatives as well as to any other business structure. Integration, amalgamation, alliances or joint ventures with other co-operatives or with investor-oriented firms (IOF) internationally is common, situating co-operatives worldwide at an unprecedented period of changes (Wilson 1999, O'Connor & Thompson, 2001).

As Lang (1995, p. 1163) stated: *“Co-operatives are at a crossroads in their development. The future of co-operatives depends on the ability of their leaders to convince members to structure themselves in order to compete on multi-commodity, value added and global bases”*.

For this research project, internationalisation of co-operatives is understood as the process by which agricultural co-operatives are involved in international business relationships, ranging from direct exporting to the formation of transnational co-operatives.

Much has been written over the last years about the dangers that globalisation implies for local farmers/producers, arguing that the main beneficiaries of trade liberalisation and the so called globalisation process have been multinational companies which can move production factors from country to country easily, putting local producers under increased and unfair competition. Even though it is well known that multinational and global IOFs have been the most efficient actors in maximising the benefits of globalisation, this is not their exclusive territory. The risks and pressures of this new global market place are big, but also big are the opportunities for farmers and food producers if they are able to exploit them. Agricultural co-operatives in the developed world were historically able to oppose or weaken the reigning of multinational IOFs (Bager, 1997).

This research project aims to identify issues related to a producer-owned and producer-controlled firm, an agricultural co-operative, gaining from globalisation by internationalising its business.

The reasons for internationalisation are several: continued growth, utilization of economies of scale, strengthening of competitiveness, utilization of know-how, access to export markets, direct presence in important markets, ability to seek resources abroad, global learning, etc. (Hymer, 1976; Rugman, 1980; Bartlett & Ghoshal, 2000). Also, besides the well known advantages of internationalisation for every form of business, there are some particular advantages of the co-operative form that should not be under-estimated, and must be identified in order to be maximised (Grosskopf, 1996; Nilsson 1996; Seipel & Heffernan, 1997).

Some disadvantages and inherent limitations of co-operatives in comparison with investor-oriented firms must be overcome first before internationalising. These reasonably well-identified barriers that co-operatives have to overcome when internationalising include capital or financing problems (associated with what has been called the horizon problem, the free rider problem and the portfolio problem), the decision-making problem, and the monitoring problem among the most important ones (Book 1992; Nilsson 1996; Schroder, Wallace & Mavondo, 1993; Seipel & Heffernan, 1997).

Most of the existing studies have either been only descriptive or have focused on the necessary restructuring for co-operatives to internationalise (Schroder et al., 1993; Normark, 1996; Mauget & Declerck, 1996; Federation of Danish Co-operatives, 2000), but no attention has been paid to the potential generation of internal conflicts that the aforementioned problems generate, the solutions to those problems, or even the whole internationalisation strategy per se.

1.2 Problem statement.

Maximising members' returns while serving and representing them are the objectives of a co-operative, and it is on behalf of those goals, and as a response to external pressures that co-

operatives have internationalised in order to successfully compete with their investor-owned counterparts. But this internationalisation and growth process can in turn detonate some internal conflicts in the co-operative, perhaps the most important of these being the loss of proximity, both physical or psychological, to its members. The point is, how to respond to the existing pressures to grow, without generating conflicts with the co-operative values, and without distancing from its members? Or if conflicts are generated, how to overcome them?

Several co-operative researchers have warned about the importance of this topic. Van de Zwan (1996) argued that modern, large co-operatives are too isolated from their members, where members have been relegated to the sidelines becoming more or less just suppliers of raw produce. In't Veld (1996) goes further, warning that high dangers lie in the depersonalisation of member relationships that some co-operatives are experiencing, as this could even result in the end of the co-operative.

In terms of the generation of conflicts, global sourcing for example, can be seen as a reason and advantage of internationalising as well as a barrier to it. The Federation of Danish Co-operatives in a study of internationalisation stated: "*Multinational companies are free to find the cheapest raw products across borders. In principle co-operatives can do the same, but at the same time they must carefully consider the consequences for the production of members*" (Federation of Danish Cooperatives, 2000, p. 7)

The USDA (1997) also gave extreme importance to the issue stating that co-operatives must balance the interest of producer-members with the need to compete in a dynamic and competitive marketplace through globally focused strategies, which are in turn essential to the interests of members.

Of special interest are Normark's (1996) comments, stating that proposals of strategic changes such as internationalisation are often evaluated from the viewpoint of effectiveness for the co-operative without paying much attention to the member's perspective. On the same mood Van Dijk (1996) stated: "*Strategic policies such as scaling up, internationalisation or vertical integration, must be judged against the aims of co-operatives' members...That sounds simple, but is hardly the case*" (p. 176).

Based on the research gap that exists in such an important topic, the main research question that this project aimed to answer is:

How can agricultural co-operatives internationalise without generating conflicts with or distancing themselves from their members?

This main question was subdivided as follows:

- 1) What are the available strategic alternatives to agricultural co-operatives to internationalise? What are the implications of these alternatives for the co-operative and its members?
- 2) What are the potential conflicts that may arise because of the internationalisation of an agricultural co-operative? How can these be best overcome?

1.3 Objectives of the research

The main objective of this project is to focus on how to manage the strategic issues that a co-operative must face when growing internationally, serving its members and remaining close to them. In order to best reach that objective, the following steps were followed:

- Definition of the organizational changes, structures, process and sources of financial resources (among others) of co-operatives that are essential for the internationalisation process to work. Information was obtained from theory and foreign case studies (Literature review)
- Analysis of the strategies available to co-operatives, determining how to best reach the objectives of an international organisation, but applied to the specific characteristics of the co-operative form
- Description and understanding of the current position of the NZ studied co-operatives in their internationalisation process. Analysis of their internationalisation strategy and the

reasons behind it, evaluating the implications of those strategies, within the gathered framework of theory and evidence of co-operatives' international activity

- Identification of the risks that internationalisation implies for the co-operatives, as well as the potential conflicts the identified internationalisation strategy can generate in terms of the integration of the co-operative with its members (e.g. positive effects for the co-operative but negative for the members). Risks were understood as 'the possibilities of occurring misfortune' and conflicts as the 'state of opposition between simultaneous interests' (Collins, 2000).
- Description of the structures and mechanisms the studied co-operative have in place in order to maintain closeness to its members and avoid/overcome conflicts. Comparison the findings with foreign experiences.
- Undertake a comparison between the two studied co-operatives in order to be able to draw some generalisations.

1.4 Relevance of the research

Despite the importance of agricultural co-operatives in New Zealand's agricultural sector and in its economy as a whole, it is surprising how little local research has been done related to them. In fact no co-operative specialized centre, institute or university exists in New Zealand, in contrast to the case in several Australian, European, and American universities. As a consequence, most of the studies of changes affecting agricultural co-operatives are from overseas, either from Europe or the US.

Most of the co-operative related body of studies relates to recent structural changes of co-operatives (e.g. New Generation co-operatives), also some studies relate to strategies and forms (market entry) of internationalisation followed by co-operatives.

This project helps to overcome an identified deficit of New Zealand research in the co-operative area, and identifies opportunities for more co-operative research in a topic area that is extremely timely and relevant to New Zealand's co-operatives.

This study also aimed to contribute as an outsider to make the international perspective become an important part of the daily co-operative work, thought and of their basic identity, *“otherwise international practice will just strengthen to alienate the members from their co-operative organizations”* (Book, 1992).

In terms of the two organisations that served as case studies for this thesis, this project aims to help them to identify potential areas where attention has to be paid in relation to the identified research problem that for different reasons they might have not seen. This project also aimed to present in a structured way all the structures and mechanisms that these two organisations currently have in place for integrating the co-operative with its members/shareholders.

Last but not least, this project aimed to contribute to the international debate on internationalisation of agricultural co-operatives, which has become a very relevant issue in recent times.

1.5 Limitations of the research

Because of the number and size of the two co-operatives used for the case studies, these cannot be called typical or representative of world agricultural co-operatives, or even of New Zealand co-operatives. However they do provide insights that could be useful to other co-operatives that are focusing on internationalisation. Also the experiences of these co-operatives suggest areas where more attention has to be paid, in order to successfully navigate through the complex process of internationalisation of co-operatives.

The interviews that are the base of this study were undertaken over the period from June to September 2002, therefore the views presented are time bound. As with most postgraduate student's research projects, available time was a limitation on this research.

This project is mainly descriptive and it does not aim to evaluate the effectiveness of the structures and mechanisms that the studied organisations have in place for integrating members with their co-operatives. Further research either by other researchers or by the

studied organisations themselves could address this by doing a comprehensive survey of members.

1.6 Thesis outline

This first chapter provided a brief overview of the selected area of study and identified the problem to be studied as well. A comprehensive literature review follows in the next chapter. This literature review was constructed under three main areas: agricultural co-operatives, business internationalisation and co-operatives internationalisation.

The business internationalisation review was performed in order to understand the main forces and reasons that are driving the internationalisation of businesses (co-operatives included), making multinationals, transnational and global corporations the dominant forces in today's world markets.

The methodology used in this research follows in Chapter 3, and includes the research method, research design and the internationalisation model developed to analyse the studied co-operatives. The individual case studies and their results are in Chapter 4 and 5, and a cross-case analysis is in Chapter 6. Finally the results from the research are summarised, the conclusions are drawn, and recommendations for further research are outlined in Chapter 7.

CHAPTER TWO: LITERATURE REVIEW

2.1 Agricultural co-operatives

2.1.1 Background: Definition and principles

Principles play a central role in co-operatives and they define to a great extent the nature and role of co-operatives. Disagreement exists about what constitute the 'true co-operative principles', as they have evolved over time, and co-operatives with them (Barton, 1989). Not only that, further evolution in co-operatives and their principles are likely to occur in the future, which will allow them to contribute in a stronger way to human development (Parnell, 1995).

As a consequence, a worldwide-recognised definition of co-operative is not easy to find as they vary according to the principles that rule them (see Table 1). These different principles are the Rochdale principles, traditional principles, proportional principles, and contemporary principles (Barton, 1989).

Despite the differences, some general definitions can be found. For example: 'a *co-operative* is a user-owned and user-controlled business that distributes benefits on the basis of use' (Barton, 1989, p.1). A very similar and generally accepted definition of a co-operative - and the one that will be used for this study - states that a co-operative is an agricultural producer organisation that is user-owned, user-controlled and user-benefited (Cook, 1997; USDA, 1997).

The International Cooperative Association (ICA) definition of co-operative is the following: "A *co-operative* is 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" (ICA, 1995).

The ICA recognises six co-operative principles: open membership, democratic control, service at cost, limited return on capital, duty to educate, and cooperation among co-operatives.

When analysing the reasons behind the formation of co-operatives one can also find differences, but in general terms co-operatives are formed with the objective of providing services to agricultural producers (the members), which they as individuals, cannot provide by themselves or at least not so effectively (McBride, 1986). As a general rule, *'co-operatives are considered means of correcting or mitigating market failures'* (Harte, 1997, p. 43).

The benefits of being part of a co-operative are several. They include capital benefits with economies of scale being obvious, advantages in the timing of capital investments, bargaining power, uncertainty reduction, existence of statutory support and more relaxed tax laws, among others. So although the primary purposes of co-operatives are economic-related benefits for its members, co-operatives may pursue some non-economic objectives as well.

Table 1: Principles ruling different forms of co-operatives

	Rochdale	Traditional	Proportional	Contemporary
Control	1. Voting is by members on democratic basis (one member/ one vote)	1. Voting is by members on democratic basis	1. Voting is by members in proportional basis	1. Voting is by members-users on democratic or proportional basis
	2. Membership is open	2. Membership is open		
Ownership	3. Equity is provided by patrons	3. Equity provided by patrons	2. Equity provided by patrons in patronage proportion	2. Equity provided by patrons
	4. Equity ownership share of individual patron is limited	4. Ownership of voting stock is limited		
Benefits	5. Net income is distributed to patrons as patronage refund on a cost basis	5. Net income is distributed to patrons as patronage refunds	3. Net income is distributed to patrons as patronage refunds	3. Net income is distributed to patrons as patronage refunds
	6. Dividend on equity capital is limited	6. Dividend on equity capital is limited		

	7. Exchange of goods and services at market prices	7. Business is done primarily with member-patrons		
Others	8. Duty to educate	8. Duty to educate		
	9. Cash trading only			
	10. No unusual risk assumption			
	11. Political & religious neutrality			
	12. Equality of the sexes in membership			

Source: Barton (1989).

Agricultural co-operatives play an extremely important role throughout the developed world. According to figures from 1992-1994 of the International Co-operative Alliance (I.C.A) in the U.S. fourteen co-operatives were in the Forbes' list of 500 largest corporations. In Canada agricultural co-operatives generated 40% of total farm cash receipts while in France 30% of total agricultural sales were from co-operatives. In Germany 38% of the agricultural land was farmed by co-operatives, while in Slovakia the percentage goes up to 69%. In Israel over 80% of the agricultural production was controlled by co-operatives. In Sweden co-operatives hold 95% of the dairy market, 80% of livestock slaughtering, 70% of the seed market, and 80% of the mixed feed market. In the Netherlands co-operatives hold 60% of the wool market, 84% of the milk market, 97% of the flower market, 85% of the fruit market, and 100% of the potato starch market (ICA, 1995)

Estimates obtained from data recollected from 47 countries from Europe, North and South America, Asia, Africa and Oceania (Table 2), indicate that total sales of agricultural co-operatives account for US\$ 450 billions, from a total number of 206,000 co-operatives, grouping more than 49,5 millions of members (Centre de Gestion des Coopératives, 1995). So although the number of co-operative's members, gross sales, and total number of agricultural co-operatives varies considerably from one country to another, it can be said that in general terms the co-operative movement is extremely important all through the world, but being lead by Europe and North America (see Table 3).

Table 2: Agricultural co-operatives world situation by continent

Continent	No. of members	No. of co-operatives	Total sales (US\$ M)
Europe	19,288,023	53,315	215,616
Asia	17,463,748	118,365	118,223
Americas	6,001,492	12,249	104,491
Africa	6,649,180	22,226	8,557
Oceania	100,090	151	5,373
TOTAL	49,502,533	206,306	452,260

Source: Centre de Gestion des Cooperatives, (1995)

Note: Data on Oceania is partial.

Table 3: Agricultural co-operatives importance indicators of selected countries in Europe and North America

Country (year)	No. of co-ops	No. of members	Gross sales (US\$ m)
Canada (1993)	823	599,179	9,253
Denmark (1993)	111	109,713	10,475
Finland (1994)	202	140,700	9,014
France (1994)	16,800	720,000	74,996
Germany (1994)	5,198	3,768,000	50,632
Italy (1992)	3,549	436,207	8,542
Netherlands (1994)	271	290,147	25,461
Spain (1990)	3,116	830,040	3,016
Sweden (1994)	64	306,000	10,900
UK (1993)	498	247,542	3,842
USA (1993)	4,244	4,023,264	82,900

Source: ICA (1995)

2.1.1.1 Types of agricultural co-operatives

Co-operatives can be classified according to size (large, small), financial structure (stock and non-stock), organisational structure (centralised, federated, mixed), geographic area served (local, regional, national, transnational), function performed (marketing, supply, processing, bargaining and service), scope (vegetables, dairy, meat, etc), and the already mentioned classification according to the principles ruling them, among others classification systems (see Table 1).

Several taxonomies of co-operatives have been elaborated. Cook (1995) for example, elaborated a taxonomy for U.S. agricultural co-operatives that recognizes five stages of evolution. The first stage includes the traditional types of agricultural co-operatives, from farm credit cooperatives to traditional marketing co-operatives. At the fifth stage (and last one

so far), co-operatives are faced with three strategic choices: 1) Exit, either by liquidating or restructuring as an investor oriented firm, 2) Continue by a) looking for outside capital through joint ventures, strategic alliances, etc or b) pursue a proportionality strategy of internally generated capital, or 3) Shift into a Sapiro III, also called New Generation Co-operatives (NGC).

Van Dijk (1996) at the other side of the Atlantic elaborated a taxonomy of Dutch co-operatives, which includes from first to fourth generation co-operatives. According to his taxonomy first generation co-operatives are the traditional group of farmers joined for market-correction purposes, with second generation co-operatives penetrating further up in the marketing chain. The relatively unknown third generation co-operatives broaden their objectives, and the fourth generation co-operatives develop themselves through integrated chain-management (co-production or co-marketing) together with an outside company.

2.1.1.2 Marketing co-operatives

Within agricultural co-operatives in general, case studies of agricultural marketing co-operatives will be used, therefore it is useful to review the logic and specific principles ruling them.

The primary function of marketing cooperatives is the commercialisation of farm products from members, but differences exist in the range of functions performed in terms of reception, grading, processing, packaging, labelling, branding, storing, distributing, merchandising and selling their products.

Marketing co-operatives link members' production, product processing and food marketing. This can be done at a local, regional or international level, with the first two options being historically the chosen ones (Bager, 1997). However this picture is starting to change as will be seen later.

Traditionally, marketing and processing co-operatives have concentrated in selling their members' farm product either in raw or processed form, bargaining for better prices, storing

and handling members' product and then further processing of them, such as, for example, milk into cheese. Lately marketing co-operatives are becoming more vertically integrated, by trying to increase control all the way up to the retail level, and becoming involved in the exporting of their products as well (Cobia, 1989).

Marketing co-operatives buy input from patrons (members), so co-operative members are suppliers of the co-operative. The objective is to obtain a higher price for their products that they would obtain in the market. To avoid overproduction, marketing co-operatives may establish production restrictions, penalty schemes, simple education of members, or a mix of these (Cobia, 1989).

2.1.1.3 Agricultural co-operatives in New Zealand

Agricultural co-operatives play an extremely important role in New Zealand's agriculture, and on its whole economy. Agricultural co-operatives in New Zealand are well established and date from the 1870's. Co-operatives can be seen today in sectors such as meat, wool, pigs, fertiliser, horticulture, and dairy, being especially strong in this last sector where since the 1940's the totality of milk processing has been undertaken by co-operatives.

Co-operatives' reality in New Zealand differs among sectors. Maunier (1984) defends that one of the big the reasons for the different realities of co-operatives in the sheep and wool, meat, horticulture, and dairy industries lies in the origins of the farmers that established those industries in New Zealand. So while for example sheep farmers were in general terms wealthy and had access to capital, the more humble dairy farmers' only viable alternative for processing their products was to set up processing facilities collectively. As a consequence the first New Zealand dairy co-operative was established in 1871, seeing by the year 1900 a total of 111 co-operatives, which increased by the 1930s to over 400 co-operatives, and finally followed a merger path over the last 40 years to end up having in 2001 one large dairy co-operative, Fonterra, which handles almost the entire New Zealand milk production and marketing.

As a general rule, it can be said that co-operatives in New Zealand were established for economic motivations (Maunier, 1984), in other words for defensive purposes. One exception of that rule would be the Maori co-operatives that can be found in the sheep and beef, horticulture, and forestry industries, where employment for tribal members is one of the main objectives.

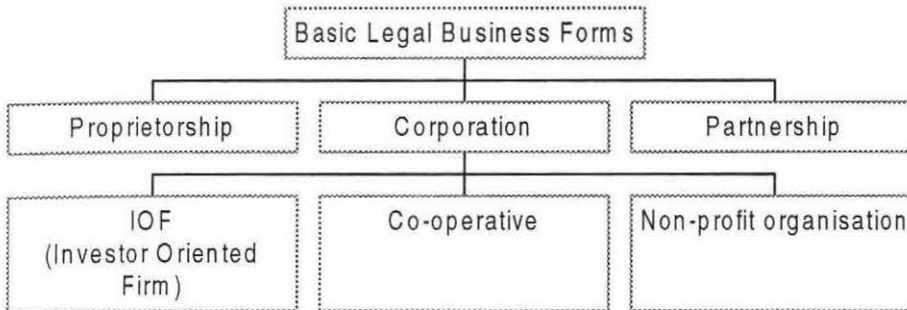
2.1.2 Unique characteristics of co-operatives

In several aspects co-operatives are similar to other forms of businesses such as Investor Oriented Firms (IOF), they may operate in similar ways, they operate in the same business environment and under the same rules, electing a Board of Directors, and hiring managers. Most importantly they share the same common objective of maximising long terms wealth of shareholders/members (Lynch, 1998). In sum they are closely related to their main competitors, the investor-oriented firm or IOF (See figure 1). On the other hand co-operatives are unique in several aspects when compared to other forms of businesses.

There are three key differences that distinguish a co-operative from other forms of business. These are the user-owner principle, which means that the persons that own and finance the co-operative are those that use it. Second there is the user-control principle, which implies that the control of the co-operative is under those who use it either on a proportional or democratic basis, and thirdly the user-benefit principle, which implies that the benefits of the co-operative are distributed to its users on the basis of their use (Barton 1989, McBride 1986, Nilsson 1996).

When comparing co-operatives with IOF, one of the most obvious differences is related to the fact that IOF owners (shareholders) have invested capital strictly in the hope of making a profit, while an agricultural co-operative is an association of farmers (members), who have invested capital as well, but who have pooled their activities (i.e. marketing) in order to make services available to themselves (McBride, 1986). As a consequence IOFs have the single objective of maximising value at firm level, but co-operatives must maximise value both at co-operative/firm level and at member level (Lynch, 1998).

Figure 1: Basic taxonomy of legal forms of organisations



Source: adapted from Barton (1989).

One of the unique characteristics of the co-operative form, which is often overlooked, is the way relationships between the co-operative members, Board of Directors, and the managers, also called the ‘management triangle’ are handled. The involvement of the members in management decisions is a critical difference with other forms of businesses (McBride, 1986). Some of the members of the Board of Directors, if not all, are co-operative members, and in some cases even the managers are cooperative members. This unique characteristic brings benefits, but also complications as will be seen later.

McBride (1986) argued that agricultural co-operatives uniqueness is closely tied with the unique characteristics of agriculture, such as climate dependence, their unique ‘management triangle’ nature, and their different motivations as opposed to IOFs.

The mentioned differences make of them a distinct form of business organisation, but at the same time they are confronted with much of the same requirements as other forms of businesses. Just as any business, and in order to compete successfully, they must be soundly financed, managed and run. This applies to national as well as to international businesses (Schroder et al., 1993).

Co-operatives traditional preconditions towards considerable capital requirements, willingness to take risks, long-term patience and fast decision-making, put them in a different and disadvantaged situation for taking part in processes like internationalisation in

comparison with other forms of business, specially against IOFs (Federation of Danish Co-operatives, 2000).

Multinationals (a type of IOFs) experience in setting up business and carrying on production abroad, together with their ability to raise capital from the share market, ensures them rapid expansion (Federation of Danish Co-operatives, 2000). All these IOF's characteristics contrast with the described co-operatives limitations, and constitute competitive advantages. This issue will be discussed latter.

2.1.3 Changes in the international scene for co-operatives

Changes affecting agriculture are a widely study field with phenomenon such as deregulation, globalisation of business and globalisation of markets affecting all forms of business. Changes in the international scenario have been one of the major forces behind the restructuring of agricultural co-operatives worldwide. Among them competition has increased, consumers have become more demanding, technological changes in logistics and storage have been drastic, retailers have become more powerful and concentrated, and the whole globalisation of the economy has resulted in economies of scale in production, logistics and marketing (Bijman, Hendrikse & Veerman, 2000).

Agricultural co-operatives are being confronted with a number of economic and social trends, such as the saturation of agricultural markets in the developed world, stagnation in sales of primary products (even though processed products show a clear growth market), and the already mentioned tremendously increased power of retailers (achieved through concentration), which will all demand a revision of co-operatives' strategies (Verheijen & Heijbroek, 1994). The increased market power of large retailers does not only mean greater bargaining power for them (and less for co-operatives), it also implies higher specifications demands, and increased competition against retailer's brands, among other sources of pressure for food producers.

As a consequence of deregulation and globalisation, competitiveness is increasing, impacting on co-operatives as it is on other types of business. But while some of the weaknesses of the

traditional co-operative model are being exposed, on the other hand, co-operatives' major competitors, multinational corporations such as Nestlé, Unilever, Phillip Morris group, or General Mills, are actively expanding their activities through acquisitions and joint ventures, making the food industry more concentrated (Schroder et al., 1993; O'Connor & Thompson, 2001; Wilson 1999).

With the drastic explosion in international trade that the world has seen over the past 40 years, co-operatives have also become increasingly involved in exporting. Agricultural markets have become global rather than local, with the opportunities and challenges this implies. Risks are magnified in the export market by multiple factors such as currency exchange, transportation, sanitary and phytosanitary barriers, etc (Bijman et al., 2000).

Finally, besides the mentioned concentration in the food chain, co-operatives have seen a worldwide trend of government support reduction, undermining some of the benefits of being in a co-operative (Harte, 1997; Wilson, 1999).

2.1.4 International trends in agricultural co-operatives

It should be noted that differences among co-operatives in different countries and sectors are considerable. For example, in Europe, co-operatives play a major role in countries like France, Ireland, Germany, Belgium, The Netherlands, and the Nordic countries while in Eastern Europe they play a marginal role. The same happens among sectors such as dairy where co-operatives have an extremely high market share, compared with others where they have little or no power (Bager, 1997). When the comparison is made against co-operatives in the developing world, differences are much larger. Also the existence of substantial subsidies paid to agricultural producers in some developed countries (Europe and US), contrasts with the lack of help from the state in others, and makes the picture even more fragmented.

However, despite the previous point '*co-operatives around the world find themselves in a period of major, perhaps unprecedented changes*' (O'Connor & Thompson, 2001, p.1).

“Integration in the milk sector, amalgamation of farmer owned meat businesses, joint ventures with co-operatives or in the private sector across national boundaries is commonplace through the food chain” (Wilson, 1999).

Several authors such as Nilsson (1998), Wilson (1999) and O’Connor & Thompson (2001) have performed international descriptions of worldwide trends of agricultural co-operatives, focusing especially on structural changes.

Nilsson (1998) in a description of co-operatives’ world trends, painted the following world scenario: Danish and Norwegian co-operatives are currently on a discussion process in order to undertake extensive changes (strategic alliances, external partnership, introduction of different categories of memberships, etc). Irish co-operatives have gone through a radical organizational change with some of them accepting private companies either as members or subsidiaries. A similar phenomenon happened in the U.K., where more than ten of the larger co-operatives became private companies with farmers as primary owners (called farmer-controlled businesses). Finally in the United States, during the 1990’s a group of new co-operative business structures have been formed, receiving the name of New Generation Co-operatives (NGC), which have been deeply studied over the past years (see for example Cook, 1995 and 1996; Nilsson, 1998; Plunkett & Kingwell, 2001).

Wilson (1999) found some contrasts in his review of the co-operative world. First, in what he calls ‘demutualisation of co-operatives’ he saw a growing trend in several developed countries, associated with deregulation and public policies, which favours investor owned businesses. Bucking the trend, he described private businesses in the U.S. being co-operativised, experiencing a revolution in the development of NGC for value-added purposes.

In complete contrast, Wilson described co-operatives in Central and Eastern Europe still adversely influenced by years of weak state management. In the West/East axis, specifically in Finland, he found a renewed interest in the co-operative form, with new co-operatives being constantly formed, many with specific rural interests in tourism, the environment, biological products, and energy production. Finally in the Netherlands, traditionally seen as a model for elsewhere, he described a normal evolutionary change driven by market demand,

with first generation co-operatives becoming rare, evolving into second, third or even fourth level.

The major changes observed by O'Connor & Thompson (2001) in a tour of agricultural co-operatives in the U.S and Europe were: (I) Changes in co-operative size and growth strategies, with large, horizontally integrated co-operatives being formed mainly through merges, (II) Changes in capital management, with for example, Land O'Lakes and Dairy Farmers of America in the U.S., requiring new members to make additional capital contributions; or Kerry Group in Ireland, listing on the stock exchange; or Campina-Melkunie in the Netherlands, requiring members to make loans to the co-operative and paying a commercial return, and (III) Changes in governance and control, with the inclusion of outside Directors to the Board of Directors, and scrutiny by outside experts of the co-operative's capital management.

The world trend of mergers of co-operatives has been especially strong in some sectors, such as the dairy industry. The majority of agricultural co-operatives have remained (so far) as pure co-operatives, whilst some have introduced different forms at primary and secondary levels, all permutations of retaining user control with benefits going to users as their primary objective. Despite this shift to fewer and larger corporate-co-operatives, there is a counter swing by the formation of new groups such as machinery rings in the last decade or farmer markets more recently, which show that the culture for co-operation is still strong (Wilson, 1999).

The nature, structure and professionalism of cooperatives have been changing. Emphasis today is placed on co-operation rather than the legal form of the business. One of the faces of this shift is that several long established farmer-owned societies have converted into limited companies (Nilsson, 1998; Wilson, 1999).

Strandskov (1997) sees in complete vertical integration the only way out of current pressures faced by co-operatives worldwide (as in his homeland Denmark). He uses the example of Danish pig co-operatives, where through vertical integration, co-operatives should control breeding, fattening, slaughtering, processing of meat, and marketing of an entire range of

products. The same would apply to dairy co-operatives, as well as to other agricultural co-operatives.

Despite some differences, such as the ones described by Wilson, the issues facing co-operatives are universal, the choices and need for change are different only because of local laws, regulations, and local market anomalies (Cook, 1996).

2.1.5 Emergence of new co-operative models

'The structures and strategies of co-operatives ... are all being questioned [or should be] as local and national food systems become integrated into a new, global food system' (Cook, 1996, p. 143, emphasis added).

As a consequence of the agricultural co-operatives intent of remaining competitive within the increasingly internationalised, deregulated and demanding markets previously described, and in order to overcome a numbers of limitations inherent to the traditional form of co-operative, several new co-operative models have been emerging over the last years (Cook, 1995; Nilsson, 1996; Straskov, 1996).

The main inherent limitations that these new models have been trying to overcome have been well studied and can be summarised as the common property problem, the portfolio problem, the horizon problem, the decision-making problem, and the control problem (Nilsson, 1996). Harte (1997) condensed them as the horizon problem, the portfolio problem, and the control problem. Using other words but following the same logic Cook (1995) identified the main co-operative limitations to ownership issues, control issues, and dilution of benefits issues.

According to Nilsson (1998) a new agricultural co-operative model is emerging with the primary processing being conducted within increasingly larger co-operatives with some operating even internationally, and with the trade between the co-operative and its members becoming more business-like. According to Nilsson, the traditional co-operative model with its many ideological attributes has a precarious future.

The main characteristics of this new organizational model that Nilsson described are: differentiation between phases in the processing chain with the collection and first stages of processing remaining in the co-operative, and with the subsequent processing being conducted by partly-owned subsidiaries. Market orientation is pursued in the subsequent stages of the processing chain, with farmer controlled, investors-partly owned businesses. Business operations are internationalised, both at marketing and production. This model fits with the current reality of Irish and U.K co-operatives.

Although not strictly a co-operative, the Co-operative PLC model followed by several Irish co-operatives such as the Kerry Group, started as a funding mechanism, but according to Harte (1997) it represented an effective way to overcome the traditional co-operative limitations and is considered by the author an efficiency enhancing development, although it must be stated that the percentage of shares held in co-operative control decreased substantially from 83.1% in 1986 to 54.8% in 1993.

In the United States a new model of agricultural co-operative has emerged, called New Generation Cooperative (NGC), which has been intensely studied in the recent years as a possible solution to overcome the traditional co-operative limitations (capital, governance and control) as a business model (Cook, 1995 & 1996). NGCs are typically (with exceptions) small, high-focused commodity co-operatives. The core characteristic and main difference of the NGC is that capital is not treated as common property; instead members hold a number of shares proportional to their delivery rights. In other words property rights are formally defined. The use of equity tradable shares among shareholders/farmers is also an extremely interesting characteristic..

Other interesting characteristics of NGC are: closed memberships, and the requirement of full contribution to equity capital when joining (O'Connor & Thompson, 2001). NGC major focus is on value-added processing (as opposed to the traditional commodity marketing), operating with a two-way contract between members and the co-operative for a certain and restricted amount of product (Cook, 1996).

According to Egerstrom (1996), the key difference of NGC lies in the fact that they are an offensive response to markets (as opposed to the traditional defensive response of co-

operatives), by using value-added activities, and processing of specialty products. Frampton (2002) argues that the NGC model enable to increase the farmer's share along the value chain, and that some of the traditional limitations of co-operatives can be overcome without weakening the essential co-operative principles.

Local adaptations of this NGC model have been implemented in Australia (Plunkett & Kingwell, 2001), New Zealand (Frampton, 2002), and Canada (Ketilson, 1997) among other developed countries.

Finally, Stranskov (1996) identified four co-operative models that were taking form as a response to the changes in the food-marketing sector. They were (I) the Independent farmer-owned company, (II) the Investment stock company, (III) the Strategic partner co-operative, and (IV) a combination of the first two models. The first model consists of large farmer-controlled co-operatives, with outside institutional investors (most likely pension funds in the Danish case). The second model assumes internationalisation of the co-operative in order to capture new markets. In the third model co-operatives would concentrate in their traditional activities, supply of raw products, and would leave other activities, such as marketing, to an outside strategic partner. Finally in the fourth model, co-operatives will form strategic alliances with cross-border companies or co-operatives, in order to increase their market influence.

As a consequences of the dramatic geopolitical changes currently taking place in Europe, Grosskopf (1996) predicted that European co-operatives of the future will operate with three classes of members: user-members but non-owners, classic owner-user members, and financial non-owner members. In terms of transnational organisation, he sees two models of 'European Union co-operative' taking shape. The first one is a truly international co-operative with members having direct ownership and membership rights across national boundaries. The second possible model, and more likely to happen according to the author, is an interregional entity or joint stock company, owned by regional co-operative members.

2.1.6 Future opportunities and challenges

“Co-operatives are at a crossroads in their development. The future of co-operatives depends on the ability of their leaders to convince members to structure themselves in order to compete on multi-commodity, value added and global bases” (Lang, 1995, p. 4).

A mix of positivism and negativism can be perceived when reviewing the specialised literature, in relation to the future of co-operatives. Some authors (Bager, 1997; Wilson 1999) argue that there are clear signs that co-operatives will be a definite feature of agriculture in the 21st century, as industry leaders are positively promoting co-operation, governments are giving its selective support and the principal retail outlets are positive in establishing more contractual commitments with them as they are looking for a limited number of fairly large suppliers.

Grosskopf (1996) on the other hand, although recognises that no intrinsic reason stops co-operatives being efficient and competitive, provided they have dynamic and imaginative management, warned that the movement must be rebuilt from the grass roots.

The existence of multiple possible partners, products, markets, and services options have located co-operatives at a point where significant new choices are again essential. Rational selection among these options requires strategic planning, strategic choices, and commitment by co-operative members (Lang, 1995).

Greater responsibility lies now over the co-operative’s Board of Directors, in order to seize opportunities, and understand that co-operative philosophy and principles are not inconsistent with the requirements of the dynamic competitive environment (Wilson, 1999; Verheijen & Heijbroek, 1994). *“Historically, co-operation has flourished in times of adversity”* (Wilson, 1999, p.100).

Consensus exists in the specialised literature, that co-operatives have to move closer to the consumer and reach further up the value chain where more profits can be found (value- added activities). Most agricultural co-operatives are still concentrated on the early stages of the

food chain, where little value is added, and therefore little profits are obtained. Co-operatives and their members must be convinced that they need to invest and move up the value chain (Lang, 1995; Strandskov, 1997).

Traditionally co-operatives have focused in obtaining economies of scale to reduce input prices or by collaboration to improve marketing effectiveness. Although these functions are still relevant, there are new rationales for co-operation. The objective in business co-operation must be to make the value chain more efficient, and therefore more profitable. This can be reached by pooling assets, time and knowledge (Wilson, 1999).

An important issue is however, how close to the final consumer should (and realistically can) co-operative get, because even though the potential rewards are attractive, co-operatives that decide to vertically integrate and market final consumer products are faced with several challenges such as the developing of a customer-oriented organisation, the establishing of a recognised brand, advertising campaigns, constant development of new products, and others which may prove difficult and expensive to achieve (Cobia, 1989). It is interesting to note related to this point the existence of retail co-operative chains such as Foodstuffs in New Zealand.

In terms of product differentiation, it is increasingly likely that both domestic and international markets will call for differentiated consumer products rather than commodities. The more promising opportunities of the future for co-operatives may lie in development of new, customised products, which will increasingly be produced, processed, and marketed outside of traditional channels (Seipel & Heffernan, 1997).

Also, with the expansion of regional pacts (NAFTA, EU, Mercosur), co-operative members are beginning to understand the value of welcoming foreign producers of complementary products under the co-operative umbrella. Co-operatives will continue to expand beyond exporting into other offshore activities, which in turn will enhance the presence and visibility of co-operative members in markets around the world (USDA, 1997).

Book (1992) argues that internationalisation should be present in all planning and strategy development by co-operatives. According to him the distribution of activities between local and national levels should increasingly be considered in the international context, especially in connection with renewals and new investments.

Recognising that globalisation has put co-operatives under enormous pressure, the International Co-operative Association (ICA) challenges co-operatives to respond to changes with more changes. *'Flexibility is - or should be - one of the greatest advantages of the co-operative form of enterprise'* (ICA, 2001, emphasis added).

Wilson (1999) agrees 'with the former statement, and argues *'the future should be about redesigning the structure, after changing the attitude, providing a better service, higher quality, greater reliability and competitive pricing from a position of commercial strength, linked to a strong brand'* (p. 105). In short, radical changes.

2.2 Internationalisation of business

2.2.1 Internationalisation motivations

There are several reasons for a company to internationalise, although companies are rarely driven by a single motivation. The motives to expand internationally could be to find new markets, secure key supplies (especially natural resources and raw materials), find low-cost production facilities, increase economies of scale (reduce unit costs), increase research and development, global scanning and learning capabilities, competitive positioning (cross subsidy, dumping), or risk reduction. As will be seen, the motivation depends on the stage of development of the corporation and the industry (Bartlett & Ghoshal, 2000).

Hymer (1976) identified control as the main reason why firms decide to internationalise and establish foreign operations (FDI), instead of just exporting to those markets. The control

advantage of foreign operations lies in the existence of market imperfections, such as trade barriers, imperfect information, or oligopolistic markets, according to the author. This is the foundation of the Internalisation theory.

According to the supporters of the Internalisation theory, which will be discussed later, exporting would be the ideal alternative if free trade was a reality. Because free trade is far from being a reality, Foreign Direct Investment (FDI) is the best alternative for firms in order to internationalise, rather than exporting or licensing (Rugman, 1980).

It has been observed that motivations alone are not enough, so firms when deciding their international business arrangements, base their decisions greatly on the firm's ownership advantages (O), such as patents, blue prints or specific know how; location advantages (L), such as advantages in geographical position, access to bigger markets or cheaper raw materials, and internalisation advantages (I), such as the efficiency gains of performing an activity abroad. Firms internationalise because of the specific combination of these OLI advantages. In order to internationalise firms must have specific competitive advantages, also called 'strategic competencies', to be able to beat the firms they will meet in foreign markets. In other words the advantages of internationalising must overcome the costs of doing so (Dunning, 1981).

Perlmutter (2000) expanded these necessary motivations and conditions to internationalise, adding that the general philosophy of a firm's management staff is a critical component. In other words the internationalisation of a firm is strongly determined by the internationalisation attitude of its managers.

Bartlett & Ghoshal (2000) distinguish between traditional motivations and emerging motivations. Traditional motivations include the necessity to secure key supplies and scarce raw materials, market seeking, and access to low-cost factors of production such as labour. These traditional motivations were behind most of the international expansion of companies post World War II. By the 1980's new motivations emerged as a consequence of the business environment getting more complex and sophisticated. These emerging motivations include

research and development amortisation, economies of scale, global scanning and learning capabilities, and competitive positioning.

Internationalisation is a necessity that no longer applies only to traditional businesses but to all activities, such as for example higher education (See Rudzki, 1995, p. 431). *'In a world that is changing ever more rapidly, universities need to adapt if they are to avoid stagnation, decline and eventual extinction. In such circumstances the necessity to internationalise becomes an imperative...'* It can be noted that exactly the same concept could be applied to almost every form of business in every area, without altering the meaning and veracity of the statement.

2.2.1.1 International, multinational, global, and transnational: differences

The difference between an international, a multinational and a global company are very subtle and can be subjectively manipulated. The real difference lies on the mentality predominating in the management teams of these corporations. Thus in an international corporation the dominating mentality will be ethnocentric, the multinational corporation will have a strong polycentric mentality, and finally the global corporation will be dominated by the geocentric view (Perlmutter, 2000).

Bartlett & Ghoshal (2000) distinguish four types of international companies, based in terms of their strategy. They are the international, the multidomestic or multinational, the global and the transnational company. The international organisation basically transfers core competencies from the local market to foreign markets. The multidomestic organisation has decentralised operations spread through the world, focusing strongly in local responsiveness, as opposed to global firms, which focus in the exploitation of scale economies, replicating process and products in all its markets. Finally the transnational organisation has its physical assets dispersed internationally, but interdependent, aiming to simultaneously exploiting economies of scale benefits, local responsiveness and global learning.

For the purposes of this text the term 'multinational' is used when referring to companies with operations or activities in more than one country (as opposed to national/domestic companies).

2.2.2 Barriers to internationalisation

When deciding to internationalise, firms face a list of barriers or problems that must be overcome in order to succeed on its international adventure, including financial barriers, cultural barriers, language barriers and others. Cultural and political forces, different national consumer patterns, local tastes and preferences, are all forces pushing for local differentiation, therefore giving local companies advantages when responding to local needs (Bartlett & Ghoshal, 2000).

The influence of culture over business organisation, systems and processes can determine in some cases totally different management traditions, which in turn can work as forces against internationalisation, making the task of doing business in foreign countries difficult (Schneider & Barsoux, 1997).

Every organisation must overcome internal barriers or limitations in order to internationalise. Rudzki (1995) for example identified the critical factors for successful internationalisation of universities: staff attitudes, senior management support, international experience of staff, availability of funds, foreign partners quality, etc.

Besides the 'natural' barriers that firms have to face when internationalising, trade barriers must also be considered. Even though economic theory suggests that free trade is the optimum policy for world wealth, protectionism has never retreated totally over the past two hundred years, being perhaps the most common policy over that period and being still today incredibly strong. *'Protectionist commercial policies have existed as long as there has been international trade'* (Capie, 1992, p. ix).

With the aims of promoting stable exchange rates and expanding international trade, a number of international organisations were created after the World War II, these being The International Monetary Fund (IMF) and the General Agreement on Tariffs and Trade (GATT) predecessor of the World Trade Organisation (WTO) (Capie, 1992).

Although the trade liberalisation process initiated by the GATT and the WTO have been very successful in bringing down barriers to international trade of products and services, important sectors such as agriculture and textiles/clothing have been less benefited. Beside tariffs, non-tariff barriers such as import quotas, voluntary export quotas, discriminatory customs valuation, and sanitary and phytosanitary barriers have increased considerably in importance since the 1970s, giving form to what is known as the 'New Protectionism' (Greenaway & Hine, 1991).

The emergence of anti-globalisation and therefore anti-internationalisation of business over the last years cannot be overlooked. Harding (2001) in an extremely interesting report prepared for the Financial Times Magazine, describes the Anti-globalisation Movement as a *"movement of movements...anti-globalisation activism is diverse and inchoate, without a unified agenda or traditional leadership"* (Harding, 2001, p.3). Governments and big multinational companies have had to face the issue that anti-globalisation activists can no longer be ignored. Protests in Washington, Melbourne, Prague, Seoul, Barcelona, Washington DC, Quebec, Gothenburg and Genoa are the visible face of a movement that is increasingly well co-ordinated, well informed and well funded, with Seattle being seen as the turning point.

An interesting point that Harding (2001) states is that these anti-globalisation activists or 'counter-capitalists' are in fact 'by-products of the globalisation', being financed by global companies such as Ford and Unilever, and even government organisations such as the European Commission of the EU, using the Internet as their main instrument of communication and coordination, being backed by respected economists, business people with PhDs in foreign countries, and having as leaders and financiers former capitalists representatives such as Douglas Tompkins (Esprit), Anita Roddick (Bodyshop chain stores), Richard Goldman (Levi's), George Soros, and the Rockefeller foundation.

Finally it is interesting to note that some of the supposed beneficiaries, the developing countries from the South, consider the North's anti-globalisation movements a set of protectionist measures to deny the developing world the benefits of economic growth (Harding, 2001).

2.2.3 Theories of business internationalisation

Several theories have tried so far to explain the Internationalisation of businesses. Among the most recognized ones are the Product Cycle theory (1960's), The Internationalisation Process Theory (1970's), The Internalisation theory (late 1970's), the Network Theory (1980's) and finally Michael Porter's (1985) theories, through his concepts of the value chain and competitive advantage.

The Product Cycle Theory (Vernon, 1966) suggests that internationalisation starts when a local company (usually from a developed country) creates an innovating product/process, which after the local market is satisfied will be exported. As the product matures, to prevent competition and to meet foreign demand more effectively, the innovating company sets up production facilities in the importing countries. Finally as the product becomes highly standardised with many competitors in the business, the company moves its facilities to low-cost locations (typically developing countries), and the original exporting-developed country ends up importing the product after it has closed its own manufacturing facilities.

The Internationalisation Process Theory, originally formulated at the Uppsala University in Sweden, argues that the internationalisation of firms occurs in small steps following the typical pattern of starting exports to foreign countries through an agent, later the establishment of a sales subsidiary, and eventually full production in the host country. Therefore internationalisation would be the product of a series of incremental decisions (Johanson & Vahlne, 1977; Rugman, 1980).

Market knowledge (both objective and experiential) and market commitment (amount of resources committed and the degree of commitment), affect commitment decisions regarding problems and opportunities, and the way current activities are performed, which in turn lead to an increase in market knowledge and commitment in a virtuous cycle of actions (Johanson & Vahlne, 1977).

Even though the internationalisation process model is accepted in the research community as a valid description, it came under criticism as it was considered too deterministic and general, being less valid in situations in which both the market and the firm are highly internationalised (Johanson & Mattsson, 1997). As a consequence the alternative internalisation model and the network approach appeared.

The Internalisation theory in contrast with the Internationalisation Process theory, affirms that companies consider explicitly the relative costs of servicing foreign markets in one of three alternative ways. First by exporting, then the firm may engage in foreign direct investment (setting of subsidiary), and third the firm may license to a possible host country producer (Rugman, 1980). The method or way of servicing a foreign market may change over time, according to conditions. Control and the advantage of keeping the competitive advantages within the firm would be according to this theory the main reason for internationalising.

In general exporting will take place when no barriers to free trade exist (unlikely to happen in agriculture). Foreign direct investment (FDI) will take place when such barriers exist. Licensing is considered an inferior alternative, as the company will eventually lose its firm specific advantage. According to the internalisation theory, through the establishment of FDI the firm specific advantages are best exploited.

The Network theory (Ford, Hakansson, & Johanson, 1997), establishes that both the internationalisation state of the market and the internationalisation state of the firm influence the internationalisation process. As a consequence four different situations can be distinguished: the early starter, the lonely international, the late starter and the international among others. According to this theory the internationalisation occurs by 1) International

extension (new contacts), 2) Penetration of existing networks, and 3) International integration of networks.

2.2.4 Forms of market entry (service mode)

As it was previously seen, the firms' strategy of penetration in international markets, depends on several factors, such as the degree of internationalisation of the firm, the degree of internationalisation of the industry, or both. A company will choose among several alternatives for entering and servicing a determined foreign market (Ford et al., 1997). These alternatives include: direct export, use of local agent or dealer network, establishment of subsidiary, acquisition of local company, joint venture (including franchising), licensing, and strategic alliance. These alternatives range, in general terms, from less committed to more committed forms, when referring to the degree of commitment of a firm.

Enderwick & Akoorie (1996) classified the alternative overseas market servicing modes as only three: exporting, FDI, and knowledge agreements. As known, the first two imply the sale of goods and services. Knowledge agreements, implies the sale of know-how, and ranges from sale of technology to licensing and franchising.

According to Porter (1985) the nature of the industry in question, determines the strategy and market entry method. He distinguishes 'multidomestic industries', such as retailing, consumer packaged goods, insurance, and finance; and "global industries", such as commercial aircrafts, semiconductors, watches, and automobiles, among others. So in a multidomestic industry, a firm can and should manage its international activities like a portfolio, but in a global industry a firm must integrate its activities on a worldwide basis.

Firms, even those that are already in an advanced stage of internationalisation, are continuously faced with the dilemma of deciding the appropriate market entry strategy for a determined new market/country (Bartlett & O'Connell, 1998). It is wrong to assume that large corporations would not be engaged in simple exporting, as evidence shows that MNCs are extremely important traders/exporters, although a large part of this trade is conducted as internal trade or intra-firm trade of intermediate goods (Enderwick & Akoorie, 1996)

2.2.5 Internationalisation of the value chain

According to Porter's (1985) definition, a value chain comprises those strategically relevant activities that lead to competitive advantage by cost reduction, product differentiation or other means. The value chain consist of 5 primary and 4 support activities of any firm. The primary activities are inbound logistics, operations, outbound logistics, marketing & sales, and service. The support or secondary activities of a firm are firm's infrastructure, human resources management, technology development, and procurement. Activities are related by linkages, which are the relationships between the way one activity is performed at the cost of performance of the other.

Every firm has a different value chain, although value chains in the same industry may be similar. The activities within the value chain are interdependent, with numerous linkages relating them. Also linkages between the firm and its numerous suppliers, channels and customers exist. These links are what Porter (1985) calls 'vertical links'. This conglomerate of a firm, suppliers, channels and customers, with its numerous linkages is what Porter calls the 'value system'.

Both of Porter's concepts - the value chain and the value system - are important to the internationalisation of businesses, the first one as a diagnostic tool to determine and develop firms' competitive strengths by making strategic decisions such as operations location, and the second one as a way to understand the industry where the company is operating, and by that way help in the design of the organisation structure. Also it is often possible to benefit both the firm and suppliers, by jointly optimising the performance of activities, or by improving coordination, although not all interrelationships lead to competitive advantage.

Porter (1986) argues that a firm that competes internationally must decide how to spread the activities in the value chain among countries. The optimal international configuration (where in the world to perform each activity), and coordination (how activities performed in different

parts of the world are coordinated) of the activities of the value chain will imply the gaining of significant competitive advantage. So many forms of competitive advantage derive less from where the firm performs activities than from how it performs them on a worldwide basis.

Gereffi's (1999) 'global commodity chain' concept is a version of Porter's value system, identifying buyer-driven chains and producer-driven chains. In his study of the apparel commodity chain, he argues that the key to success of East-Asian buyer-driven chains was to move from the mere assembly of imported inputs to more domestically integrated and higher value-added form of exporting known as full-packaged supply. Eventually East Asians have moved further to play a coordinating role in these global sourcing networks with low-wage assembly being done in other parts of Asia, Africa, or Latin America. This has direct implications for how agricultural co-operatives can succeed by learning from the experience of other sectors.

2.2.6 Globalisation of markets and businesses

According to the dictionary definition, globalisation is "*the process enabling financial and investment markets to operate internationally, largely as a result of deregulation and improved communications*" (Collins English dictionary, 2000).

Hill (2001) defined globalisation as "*the shift toward a more integrated and interdependent world economy*" (p.5), recognising globalisation of markets and globalisation of businesses as their two main components. Globalisation of markets implies the merger of national markets into a single huge global marketplace, while globalisation of production implies the tendency among firms of sourcing goods and services from different parts of the world.

There are forces towards globalisation and forces against it. Among the causes behind globalisation we can find declining trade and investment barriers, increased global trade, growing economies in more countries, increased consumer welfare, technological changes

specially in information, telecommunications and transport, less involvement of government and privatisation of state-controlled industries (Bartlett & Ghoshal 2000, Porter 1985)

Economies of scale (driving down per unit costs), economies of scope, and national differences in different productive resources have been described as the three main forces driving globalisation of businesses (Bartlett & Ghoshal, 2000).

Porter (1986) recognized the existence of 'global industries' or sectors. Porter argues that an industry is global if there is some competitive advantage in integrating the strategically relevant activities of the value chain in a worldwide basis. Competitive advantage comes from low relative cost or differentiation in some other way.

Yip (2000) summarised the drivers of globalisation in: (I) Market drivers, which included homogeneous customer needs, the existence of global customers and global channels, transferable marketing, (II) Cost drivers, which included economies of scale and economies of scope, learning curves, sourcing and logistics efficiencies, differences in country costs and skills and product development costs, (III) Governmental drivers, which included favourable trade policies, compatible technical standards, and common marketing regulations, and (IV) Competitive drivers, which included interdependence of countries and the existence of globalised competitors.

Levitt (1983) defended the globalisation thesis argument, and even goes further stating that the multinational firm, adapting its products and practices in each country that operates, is obsolete, and the only firms that will survive in the new market conditions will be the global firms, that is the firms that produce and market standard, global products. Levitt argues that a powerful force drives this inevitable global homogeneity, which is technology.

According to Levitt, the remaining local differences in tastes and preferences are vestiges of the past, most of them will disappear gradually, and a few will become global products, such as pizzas, jazz, pita bread, etc. But the global company, the company of the future according to him, will constantly be seeking to standardise their offer, and to do exactly the same, in the

same way, at a relatively low cost, everywhere. As examples of global companies he mentions Coca-Cola, McDonalds, KFC, and Revlon among others.

On the other hand Omaha (1989) argues, "*truly global products are few and far between*" (p. 87). According to him creating a global product means understanding, and responding to customer needs and business system requirements in every critical market. Effective global operations require equidistance of perspective, in other words to see and to think global first, and then act locally. Firms then, must be responsive to local differences, while retaining global efficiencies. This is the so-called 'transnational strategic' mentality (Bartlett & Ghoshal, 2000).

Also, the aforementioned emergence of strong anti-globalisation movements cannot be underestimated in their influence. Protesters can be seen in every international economic and political meeting, such as WTO, G7, NAFTA, and EC summits, among others. Recent events at the Genoa summit, which caused property damages, estimated at US\$45m, had massive media cover, confirming the notoriety anti-globalisation protesters have achieved (Harding, 2001).

Bartlett & Ghoshal (2000) state that the contemporary world business scenario is a mix of strong pressures toward global efficiencies (globalisation), with forces demanding local responsiveness.

2.2.7 International business strategies

Kogut (1985) argues that the design of a chosen international strategy must be the result of the interplay between the comparative advantage of a countries (or location specific advantage of a determined factor) and the competitive advantage of the firm. When firms achieve a competitive advantage in terms of scale, scope, or knowledge, they can be disadvantaged in terms of location (comparative advantage) but still compete successfully.

Porter (1986) argues that a firm's choice of international strategy involves a search for competitive advantage from coordination and configuration of the different activities of the

value chain. Finally, Bartlett & Ghoshal (2000) state that the international strategy of a firm is the result of confronting forces for global efficiencies on one hand, and local responsiveness on the other.

In differentiated goods industries, firms can respond to international competition by investing in new competitive advantages. But in commodities related industries shift in comparative advantages have only four possible responses: divestiture, switching of technologies to use factors favoured by the country comparative advantage, investments in overseas plants (foreign sourcing), or lobbying for government intervention (Kogut, 1985).

According to Porter (1986), there are four types of international strategy (see table 4): Export based strategy, country-centred strategy, high FDI strategy with coordination between subsidiaries, and a truly global strategy.

Table 4: Types of international strategies

Hi coordination of activities	(3) High foreign investment with extensive coordination among subsidiaries	(4) Pure global strategy
Low coordination of activities	(2) Country-centred strategy by multinationals with a number of domestic firms operating in only one country	(1) Export-based strategy with decentralised marketing
	Geographically dispersed	Geographically concentrated

Source: Porter (1986).

Bartlett & Ghoshal (2000) also distinguish also four internationalisation strategies, which in general terms are exactly the same as those identified by Porter, even though they use different names. The strategies identified by Bartlett & Ghoshal are (I) The simple “International strategy” used by firms recently internationalising finding larger markets overseas, (II) The integrated “Global strategy” of firms responding to global economies of scale, (III) The multidomestic “Multinational strategy”, and (IV) The “Transnational strategy”, which uses a mix of global of global and local responsiveness.

The multinational strategy focuses on national differences, using highly independent national units to respond to different customer preferences, industry characteristics, and government regulations, but the company as a whole suffers inefficiencies and lack of knowledge sharing between the different national units. The international strategy focuses on creating and exploiting innovations in a worldwide basis, without the centralisation and economies of scale operations of a global strategy. This strategy responds very well to the product cycle theory. The global strategy focuses in constructing global efficiencies through homogenisation of products, centralisation and economies of scale, with a low relative cost as a result. Finally the transnational strategy, according to the authors the best way of gaining competitive advantages, focuses in developing a mix of global efficiencies, flexibility, and global learning, through dispersed but interdependent activities and resource allocation (Bartlett & Ghoshal, 2000).

The extent and location of advantages from a determined strategy vary among industries. In some industries there are no net advantages to global strategies. So in multidomestic industries, a country-centred strategy is the best alternative. The global firm can spread activities among different countries; something a domestic country centred firm cannot (Porter, 1986).

To achieve worldwide competitive advantage a company must achieve three strategic goals: global-scale efficiency in its existing activities; multinational flexibility so as to manage diverse country-specific risks and opportunities; and ability to learn from its international exposure and opportunities, and to exploit that learning on a worldwide basis. This is what Bartlett & Ghoshal (2000) call the 'transnational strategy'. In order to achieve this, all three must be exploited simultaneously: exploiting differences in sourcing and market potential across countries, exploiting economies of scale, and finally exploiting economies of scope.

Finally it is appropriate to state that as global markets and businesses are continuously changing, strategies are changing with them. After closely studying multinationals' international behaviour over the last decade Bartlett & Ghoshal (2000) recognised what they called the fifth evolutionary stage of international strategies. This new strategy model, a transnational network of small profit centres is defined by three core processes: the

entrepreneurial process, the integration process, and the renovation process, which are in turn driven by entrepreneurial front-line managers, 'coach' senior managers, and strategic corporate leaders.

2.2.8 Structure and organisation in international business

Historical and societal context need to be considered to understand the adoption and diffusion of different forms of organisation in different countries when doing business overseas. Different attitudes towards hierarchy and authority, formality, delegation, centralisation and many others can have strong influence over the success of organisation structure functioning. Based on four dimensions – power distance, uncertainty avoidance, individualism, and masculinity - Hofstede (1980) identified four different models of organisation that would work best in different countries: the village market (Anglo/Nordic), the family or tribe (Asian), the well-oiled machine (Germanic), the pyramid of people (Latin). The findings of Hofstede seriously questioned the universal validity of management theories, usually developed in the US or the UK.

The impact of culture on organisational structure, systems and process can not be overlooked, and the dangers of best practice transfers must be considered, with firms taking in consideration that the best models are not necessary home-grown, and that alternative forms of organisation may be superior (Schneider & Barsoux, 1997)

Coordinating the diverse and complex operations of a multinational firm is a key issue in the success of the venture (see table 4). Complex international strategy requires enhancement of not just formal structure but a firm's entire management process. On the other hand a transnational organisation needs distributed capabilities that are carefully but flexibly integrated. For that purpose a strong internal organisational culture, supported by effective microstructures, strong information flows, and a shared vision are necessary (Bartlett & Ghoshal, 2000).

Table 5: Configuration of assets and capabilities in multinational companies according to their strategic orientation

Multinational	International	Global	Transnational
Decentralised and rationally self-sufficient	Sources of core competences centralised, the rest decentralised	Centralised and globally scaled	Dispersed, interdependent and specialised

Source: Bartlett & Ghoshal (2000).

Companies can gain significant competitive advantage by giving to their subsidiaries considerable autonomy but learning from their experiences. Different subsidiaries have the potential to develop specialised competencies that can improve the competitive advantage of the firm as a whole (Bartlett & Ghoshal, 2000). On the other hand difficulties in reconciling headquarters interests with those of the subsidiaries exist, and the impact of the subsidiary local business network can affect the ability of a multinational company to act globally (Andersson & Forsgren, 1995).

The transnational strategy tasks of global efficiency, local responsiveness and worldwide learning (all of them simultaneously), implies for most firms a strategic reorientation as well as an organisational one, which are extremely difficult. Such difficulties are further exacerbated by distance, time, cultural differences and language (Bartlett & Ghoshal, 2000). *“The key tasks become to reorient managers thinking and reshape the core decision-making business. The company’s entire management process activities become the tools for managing such change”* (p. 506).

Multinational firms, in order to successfully implement global strategies at a subsidiary level, use several mechanisms such as incentive schemes, monitoring systems, and rewards and punishments. But according to Kim & Mauborgne (1993) subsidiary managers (as key catalysts in any strategy implementation) are more concerned that the global strategic measures employ what they call ‘due process’. Due process implies consistent practices, with two-way communication channels, possibility of questioning or challenging by subsidiaries, knowledge of local situation by headquarters, and an explanation for final strategic decisions.

2.2.9 The internationalisation challenge: worldwide learning

One of the key advantages, maybe even the most important, but often neglected and unexploited, of an international corporation lies in its worldwide learning ability. *“In today’s market conditions, the only sure source of lasting competitive advantage is knowledge”* (Nonaka, 1986, p. 681).

According to what Nonaka (1986) calls the ‘knowledge-creating company’, firms should facilitate and enhance the continuous conversion of personal tacit knowledge into explicit knowledge within the company. But this knowledge-creating activity is not a specialised activity, in fact every worker in a firm should be involved in it.

Garvin’s (2000) theoretical ‘learning organisation’ makes continuous improvement through continuous learning, which is the consequence of a commitment to learning. According to Garvin’s three Ms, a clear definition of learning (Meaning), specific guidelines for managers (Management), and well defined learning assessing tools (Measurement), are all fundamental factors to effectively creating a learning organisation.

In the challenge of worldwide learning, and creating and leveraging knowledge, subsidiaries must act as sensors of new market trends or technological developments wherever they occur, they must also attract scarce talent and expertise on a worldwide basis, and they must act collectively to exploit new products and initiatives worldwide, regardless of where they were originated. For that purpose an effectively integrated network of free flowing ideas and innovations is necessary (Bartlett & Ghoshal, 2000).

2.3 Internationalisation of agricultural co-operatives

2.3.1 The choice of internationalisation

The Federation of Danish co-operatives (2000) defined an international co-operative as any co-operative that has initiated one or more of the following forms of internationalisation: Export, Alliances, FDI, and/or organization of transnational co-operatives. According to this definition several agricultural co-operatives in Europe, North America, Australia, and New Zealand have been international for a long time as they export a significant proportion of their production. On the other hand the number of co-operatives with production abroad, and even members abroad was traditionally quite small, if non-existent, a situation that has been changing since the 1980s (Bager, 1997).

Whether to internationalise or not, should be one extremely important decision among several strategic decisions that agricultural co-operatives are currently evaluating in order to respond to the previously described changes in world markets. Other strategic options that agricultural co-operatives have to decide about may include concentration paths (union, merger, acquisition, partnership, joint venture), diversification versus specialization, vertical integration versus horizontal integration, and cost leadership versus product differentiation (Mauget & Declerck, 1996).

Book (1992) gives to the issue extreme importance, arguing that co-operatives have the *'urgent necessity to include international levels in their organizations about the priorities for the overall effectiveness, as there will be an increasing need to use resources to identify and build up international networks'*. Grosskopf (1996) described internationalisation of co-operatives as a necessary, and somehow unavoidable - at least in the case of EC co-operatives - but dangerous process.

Salaberría (1997, p.67) stated *'co-operatives must be convinced that there is no real distinction between an internal and an external market, they must treat the world as their market, they must organize themselves for exports, establish commercial networks and branches, attend international fairs, and take part in trade delegations'*.

This pro-internationalisation theoretical background is supported by strikes evidence that only a limited number of agricultural co-operatives have expanded production into foreign markets although the number is growing (see Table 5) (Bager, 1997). Mauget & Declerck (1996) found, when comparing structures, strategies and performance of agricultural co-operatives in the EC, that expansion into international markets remained weak at that time, except for certain cooperatives (Avonmore, Waterford, Golden Vale, and Kerry Group in Ireland, MD Foods in Denmark, Campina-Melkunie in the Netherlands, Sodiaal in France), due mainly to the high costs involved, even though it is important to state that the co-operatives internationalisation trend has remained strong.

Table 6: Internationalisation of agricultural co-operatives in selected European countries.

Name of co-operative	Country	Turnover abroad (%)	Production abroad
Arkadie	France	10	No
Cana	France	17	No
Socopa	France	20	Yes
Sodiaal	France	19	Yes
Unicopa	France	22	No
Campina	Netherlands	47	Yes
Coberco	Netherlands	53	No
Coveco	Netherlands	44	No
Cehave-Encebe	Netherlands	38	No
Friesland	Netherlands	66	Yes
Avenmore	Ireland	66	Yes
An Bord Bainne	Ireland	100	Yes
Dairygold	Ireland	30	No
Golden Vale	Ireland	58	Yes
Kerry Group	Ireland	66	Yes
Waterford	Ireland	70	Yes
Danish Crown	Denmark	70	No
ESS-Food	Denmark	99	Yes
KIØver	Denmark	25	No
MD Foods	Denmark	61	No
MD Foods Intl.	Denmark	100	Yes
Vestjyske	Denmark	80	Yes

Source: Hyboldt (1994) cited in Bager (1997)

Apparently, agricultural co-operatives behave in their internationalisation according to the Internationalisation process model (Johanson & Vahlne, 1977), following a gradual progress from an experimental, to an active, to a committed stage in international operations (Buccola,

Durham, Gopinath & Henderson, 2001). So it is probable that agricultural co-operatives are in an early stage in their internationalisation process when comparing with other business forms.

Buccola et al. (2001) found that the most important factors that determine co-operatives choice of internationalisation form are the capital subscription methods, marketing objectives, foreign experience and propensity, and the nature of the products manufactured.

2.3.2 Reasons for internationalisation of agricultural co-operatives

2.3.2.1 General reasons for internationalisation of co-operatives

The reasons behind the internationalisation of agricultural co-operatives are in general terms exactly the same that push for the internationalisation of any form of business such as continued growth, utilisation of economies of scale, strengthening of competitiveness, utilisation of know-how, access to export markets, direct presence in important markets, and ability to seek resources abroad (Federation of Danish Cooperatives, 2001).

Buccola et al. (2001) shortened the list, considering that there are only three main possible reasons why cooperatives internationalise: increasing the firm's market share, enhancing average sale price, and reducing or diversifying risk.

Internationalisation of co-operatives is essential in order to have access to large buyers. By internationalising farmers and horticultural producers can develop the strength or countervailing power needed to compete more effectively (Grosskopf, 1996).

With the liberalization of trade and currency movements, as well as all measures to promote economic relations between countries, the strategic decision basis of all business forms, including co-operatives has been affected. Co-operatives have to decide now how they could internationalise sales, production and development on the basis of a division of activities in which the special preconditions of individual geographical areas are taken in consideration (Federation of Danish Co-operatives, 2000). This implies challenges as well as opportunities.

As a consequence competitive pressures have arisen, primarily from multinational companies, which are making national boundaries increasingly irrelevant through the use of new

technologies, combined with highly mobile investment capital, and global sourcing of raw materials and labour (Seipel & Heffernan, 1997). On the other hand, as it has already been stated, the particular goals and conditions of co-operatives mean that the motivations and starting points for internationalisation differ in certain areas from the IOFs ones (Federation of Danish Co-operatives, 2000). So for example, global sourcing can be a strong competitive reason for co-operatives to internationalise, but at the same time it can be a limiting factor (USDA, 1997).

The motivations and mechanisms for foreign sourcing strategies are various. So for example, sourcing of non-members raw products, which may seem contradictory at a first glance, can be related to lowering per-unit costs through greater use of plant capacity, or the fill of seasonal marketing windows for maintaining all year round availability, or for broadening the co-operatives product line (USDA, 1997). Co-operatives can also source supplemental or non-competing products, although the definition of non-competing products can sometimes be difficult to achieve. Finally co-operatives may expand their memberships to include foreign members. So foreign sourcing can be a previous step to the formation of transnational co-operatives (Federation of Danish Co-operatives, 2000).

The issue of economies of scale and reaching sufficient size is also one of the big forces behind agricultural co-operatives internationalisation. "*Sufficient size is essential for all strategic options... internationalisation or regionalisation is often a possibility and sometimes a necessity*" (Verheijen & Heijbroek, 1994, p. 174).

2.3.2.2 Co-operatives' specific advantages for internationalisation

In terms of particular reasons for internationalisation that are exclusive of co-operatives, the Federation of Danish Co-operatives (2000) argues that there are inherent advantages in the co-operative form, which make co-operatives specially suited for internationalising. These inherent advantages are the allegiance of suppliers and customers, the loyalty of members,

traceability of products, direct and indirect co-financing from new members, as well as access to financing from international lending institutions, among others.

Salaberría (1997) agrees with the former view, stating that co-operatives competitive advantages, such as the involvement and motivation of its members, benefits of the democratic organization, and its internal strength and cohesion, cannot be underestimated when considering international expansion. Although some of these same strengths can be their weaknesses and barriers for internationalisation, as will be seen.

Cook (1997) argues that agricultural co-operatives have three self-declared advantages for internationalisation: access to raw material, reputation for assured supply and quality, and persistent innovation.

Seipel & Heffernan (1997) have an optimistic view towards globalisation and the paper co-operatives will play in the immediate future. *'Current trends toward globalisation will present opportunities that co-operatives, because of the nature of their organisational structure and history will be uniquely qualified to fill'* (p. 6).

An important point is that not only large food companies in general, and co-operatives in particular can become international. Size is not a necessity for internationalising (Bager, 1997), although it is sometimes a consequence.

Grosskopf (1996) points out that one of the strengths of co-operatives for internationalisation, is in their co-operative organisational structure with its non-hierarchical and decentralised characteristics. This same structure is also a barrier to internationalisation as well, as describe later. Grosskopf argues that end-users in other countries often feel that by forming alliances with co-operatives they are aligning themselves with counterparts and assuring a consistent, high-quality supply of agricultural products. Co-operatives are often seen as highly ethical, trustworthy business partners by agricultural entities in other countries. In some consumer markets, the reaction to globalisation has been manifested in increased concerns about food safety and quality and in an interest in alternative food channels.

Co-operatives have a potential advantage over IOFs, particularly if connected to larger networks, in the motivation of the workforce, which are in turn the owners of the business (Huet, 2001). Wilson (1999) sees a possibility in the fact that principal retail outlets are positive in establishing more contractual commitments, as long as they can be surely sourced, making the picture for agricultural co-operatives look attractive.

2.3.3 Problems and barriers of co-operatives internationalisation

As opposed to what we found on the reasons behind internationalisation, the barriers and limitations to internationalisation for co-operatives are not exactly the same as those that IOFs face, even though some of them can be similar. This finding is not surprising and is consistent with the specialised literature (Book, 1992; Schroder et al., 1993; Nilsson 1996).

Co-operatives in general have lost ground in the internationalisation of their economic structures in comparison with the IOF alternative. Book (1992) argues that the basic problems behind the lack of internationalisation of co-operatives are: 1) the orientation of co-operatives activities is basically domestic in character, 2) the co-operative representatives and leaders have not been traditionally able to speak foreign languages, 3) the co-operative tradition of not letting activities in one country compete with those in other countries, and 4) the process is often slower and more complicated for co-operatives.

According to Schroder et al. (1993) there are six barriers which agricultural co-operatives, and in general Producer Marketing Organisations (PMO), have to overcome in order to internationalise or globalise. These barriers are: 1) developing of a marketing orientation instead of producer orientation which are determined by biological cycles of the raw materials, 2) the location in the food chain, as they are at the beginning of the chain far from consumers and market signals, 3) the sourcing of raw materials dilemma, 4) relationships with governments (when government support exists), 5) strategic thinking barriers, and 6) the development of a long term financing strategy.

From the six mentioned barriers, Schroder et al. (1993) stated that the first four, apply to all PMOs irrespectively of their size and stage of maturity, with the last two (producer control and sourcing dilemma) being important in the early stages of their lives.

Nilsson (1996) from the Uppsala University in Sweden stated that all co-operatives face five main problems when preparing to compete and participate in the global food markets. They are the capital problem, the portfolio problem, the horizon problem, the decision-making process problem, and the monitoring of the Board problem. The solution to all these problems, he says, necessarily involves the strengthening of influence and involvement of members. Condensing those same concepts, Lynch (1998) stated that the equity raising limitations arise from three major problems: the common property problem (or free rider problem), the horizon problem, and the portfolio problem.

Seipel & Heffernan (1997) identified as limitations to co-operative international involvements: the diverse interests of members, the aversion to higher risks associated with international investments, the horizon problem (aversion to long-term commitments with little short-term benefits), and the physical ties to domestic resource bases which may limit international activity. In terms of international involvement with foreign co-operatives, they identified the problem of different connotations (some of them bad) of the co-operative concept in some countries, and the associated consequences for making business under the 'co-operative brand'.

Cook (1997) states that co-operatives face the following constraints when internationalising in an increasingly globalised business environment: mission clarity, single origin nature, capital availability, and governance (lack of skilled outside Directors).

Even though most of the barriers mentioned by the mentioned researchers are similar, no agreement exists in the identification of the major(s) barrier(s) to the internationalisation of co-operatives, even though it could be said that some consensus exists identifying the 'financial' or 'capital problem' as a key one.

So for example, Normark (1996) argues that although some co-operatives have undergone internationalisation of their operations by using profits from existing operations, in general they are not sufficient for big international acquisitions. External loans are not a realistic source of capital either, because they would dramatically increase the level of financial risk of

the co-operative. Another, more realistic alternative, he states, would be capital from non-members sources (investors), but this solution would jeopardize the co-operative organization, as the investors goals could be different from the members' goals, and a conflict of interest could arise.

O'Connor & Thompson (2001) go further, arguing that financial/capital limitations are not only a big internationalisation barrier, but they are the origin (entirely or partially) of a big part of the traditional co-operative weaknesses, with consequences such as chronic shortage of capital, inefficient use of capital, and instability of the organization.

According to Salaberría (1997) who is President of the Confederation of Co-operatives of the Basque country (Spain), the solution to the financial problem lies in a change of co-operatives' attitudes to capital, without the intention of transforming the co-operative into a joint stock company, but by thinking of realistic and economically stimulating means of capital contributions, either from their own members or from outside members.

From a financial point of view, the shortage of capital is not the only barrier to internationalisation identified by researchers. Buccola et al. (2001) found that agricultural co-operatives have disadvantages in overseas markets arrangements (in comparison with IOFs), mentioning risk aversion as one of the most important in discouraging the extent of internationalisation. The causes behind this attitude can be found, according to the authors, in the fact that farmers are already exposed to significant input prices and yield risks, so they are less disposed to assume additional risks coming from the internationalisation of operations. This fits with Grosskopf (1996) view of international risk perception of co-operatives.

Another big limitation for co-operatives internationalisation lies in the fact that most co-operatives have ties to producers/members within a particular region, and they do not have the same freedom in shifting production and processing around the globe that IOFs have (Seipel & Heffernan, 1997). This barrier is not impossible to overcome, but as the Federation of Danish Co-operatives stated in their study of internationalisation, the consequences must be deeply analysed: *“As opposed to co-operatives, limited companies regard agricultural products as general factors of production for which there is no given pattern of preference in*

advance...being free to find the cheapest raw products across borders. In principle co-operatives can do the same, but they must carefully consider the consequences for the production of members” (Federation of Danish Cooperatives, 2000, p.7).

When studying the restructuring and merger in 1996 of nine co-operative vegetable auctions in the Netherlands into the biggest Dutch vegetable auction co-op, VTN/The Greenery International BV, Bijman et al. (2000) found that there were eight areas where the management team failed in their initial-operations year, and therefore have to be improved in order to make the restructuring successful. The areas were: 1) Growers-management relationship (increase in geographical and psychological distance), 2) Decision making structure and process, 3) Relationship with buyers, 4) Ownership and financing (acquisitions of companies were financed through debt capital), 5) Price setting (introduction of contract mediation to complement the auction system), 6) Marketing and promotion (brand development), 7) Innovation and differentiation, and 8) Rise of alternative forms of growers' organizations, like Growers' Associations.

The existence of considerable barriers does not imply at all that co-operatives cannot successfully internationalise. Schroder et al. back in 1993, stated that co-operatives and producer marketing organisations can in fact overcome the internationalisation barriers and cited the New Zealand Dairy Board (NZDB), predecessor of Fonterra, as an example of a Co-operative/PMO that was successful in overcoming the mentioned barriers.

2.3.4 Forms of co-operatives internationalisation

The internationalisation terminology differs between the business literature and the co-operative specialised literature. So for example while in the business literature (see Bartlett & Ghoshal, 2000; Hill 2001) the term 'transnational' is used to describe an organisation with its physical assets (subsidiaries) dispersed internationally, but interdependent as the most evolved form of international organisations. On the other hand, the co-operative literature defines a transnational co-operative as a co-operative with members in two or more countries

(Federation of Danish Co-operatives, 2000). To make the differentiation even more complicated it is common to find the concept internationalisation being used to describe the inclusion of co-operative members from foreign countries (Verheijen & Heijbroek, 1994).

Internationalisation of co-operatives is a world trend, with American co-operatives using foreign direct investments (FDI) forms, and Europeans co-operatives moving towards the transnational co-operative form (O'Connor & Thompson, 2001), although Mauget & Declerck (1996) found that early internationalisation of European agricultural co-operatives was often performed through acquisitions, undertaken to process agricultural products abroad.

According to Porter (1985) differentiation of multidomestic and global industries, the food industry could be classified under both categories depending if we are considering commodities (global industry) or branded products (multidomestic). A small number of co-operatives in developed countries have been active in establishing global marketing strategies for their commodity-based products (Cook, 1997).

Bager (1997) states that food companies follow three basic strategies that have implications for their optimal size and the necessity to internationalise: (1) the standard producer, which in general has high export rates but rarely has substantial production abroad (2) brand label producer, which may have both high exports volumes and production abroad (3) speciality producer, which are small producers that sell their products to high-price customers locally and abroad.

Agricultural co-operatives have been following different strategies of internationalisation. According to Normark (1996, p.54) on his study of Swedish co-operatives *'the strategy processes have been incremental, holistic and gradually testing in character... alternatives to develop more sophisticated plans has been regarded as less realistic'*, fitting with Internationalisation process theory (Johanson & Vahlne, 1977).

As mentioned before, maybe the key issue when agricultural co-operatives decide to internationalise is the necessity of finding new ways of attracting capital. Bager (1997) stated that three general models are adopted by co-operatives with strong international commitment:

the conversion to limited company; the formation of limited subsidiary, and issue of shares to members/farmers and non-farmers. Even though this classification may fit the Irish scene – where Bager did the research – it is somehow limited for applying worldwide, but still useful for comparison purposes.

Bager (1997) mentioned the Irish dairy co-operative Kerry group as an example for the conversion model, the Danish Dairy co-operative MD Foods as an example of the 'limited subsidiary model', and without specifying mentioned that a few French and Dutch co-operatives have followed the third model.

Co-operatives as well as IOFs, when internationalising use in some cases a portfolio of arrangements including trading companies, foreign distributors, brokers, licensing, and foreign direct investments, according to the product and market conditions. On the other hand, the factors influencing the election are considerably different from the IOFs ones and they are strongly based on factors such as financial resources and structure, risk exposure and risk preferences, information resources and product types (USDA 1997, Buccola et al. 2001).

The form of internationalisation that a co-operative chooses can vary considerably among co-operatives, as well as among locations (Normak, 1996). Each of the forms of internationalisation has advantages and disadvantages that must be analysed carefully in order to determine which path to follow. The choice therefore, must be based in purely economic and strategic considerations on behalf of the benefit of the co-operative members, leaving aside all other influences (political, nationalistic, etc) (Federation of Danish Co-operatives, 2000).

Overseas business arrangements can be ordered according to the degree of commitment the firm/co-operative makes in the international venture. Using this scheme, Buccola et al. (2001) ordered, from least to greatest commitment, overseas business arrangements used by co-operatives as: 1) domestic sales to an overseas trading company, 2) sales through a foreign distributor, 3) sales through a foreign broker, 4) direct sales to an overseas wholesaler or retailer, 5) overseas coventure (licensing), and 6) foreign direct investment.

Cook (1997) condensed into four basic options the role of internationalisation in agricultural and food firms' strategy: importing, exporting, FDI, and commercial relationships – including JV, coventure, franchising, licensing, and strategic alliances .

As mentioned, the Federation of Danish co-operatives (2000) definition of international co-operative includes any co-operative using one of the following forms of internationalisation: Export, Alliances, FDI, and/or organization of transnational co-operatives. However, more detailed business internationalisation studies have identified as many as nine different stages of internationalisation including: direct exporting, brokers, FDI, joint ventures, licensing, and alliances among others (see for example Bartlett & O'Connell, 1998).

For the purpose of this study however, agricultural co-operatives internationalisation forms will be classified in six big groups: Exporting, FDI, external sourcing, knowledge agreements, international alliances, and transnational co-operatives.

2.3.4.1 Exporting

Exporting, either directly or through intermediaries, is the most common way co-operatives enter international markets. In 1995, over 90 US farmer co-operatives exported agricultural products individually valued at more than US\$ 5.6 billion with around 70% of this consisting of bulk commodities (grain, oilseeds, cotton, and others). In total co-operatives' exports accounted for about 12.3% of total US agricultural exports in 1995 (USDA, 1997)

It has been observed that while some co-operatives export only in years of excess production, many consider exporting a key element in their overall marketing strategy. One interesting measure of the importance is 'export intensity' (export as a percentage of total sales) showing relatively low values in 1995, being 17.3% for bulk commodities, 13% for consumer-oriented products, and 12.4% for intermediate products (USDA, 1997).

For the purpose of this research, a wide range of business relationships are considered such as export arrangements including co-operative's foreign agents, brokers, distributors, and others. As has been already mentioned the type of arrangement used by a determined co-operative

will depend on the product, market, and availability of resources, among other things (Buccola et al., 2001).

2.3.4.2 Foreign Direct Investments (FDI)

Foreign Direct Investment (FDI), which includes a range of arrangements, from the establishment of subsidiaries to Joint-ventures (JV), is one of the most important forms of internationalisation used by co-operatives, and by corporations in general, when internationalising.

Examples of acquisition of foreign companies are plentiful and growing. For example, reports indicate that US agricultural co-operatives have been increasingly involved with FDI when internationalising. Co-operatives such as Farmland Industries, (which acquired a Swiss grain-trading firm), Calavo Foods Inc., (which has a pulp process facility in Mexico), and Growmark Inc., (which acquired the assets of the Canadian United Co-operatives), among many others can be cited as examples of US agricultural co-operatives with FDIs (USDA, 1997).

FDI can be used by agricultural co-operatives for global sourcing purposes, either to source non-competing products or complementary products, or to fill seasonal marketing windows. This last issue is especially critical in products where consumers expect year round availability, which is increasingly the case for all food products. Also foreign sourcing can broaden a co-operatives product line, e.g. Calavo Growers from California, sources persimmons, Asian pears and mangoes from overseas non-member growers to expand their product line, which consists basically of avocado (USDA, 1997).

Also, agricultural co-operatives have been increasingly using joint ventures (JV) for their internationalisation process, for example, the same Calavo Growers (largest avocado supplier in the world) has alliances and JVs in Mexico, Chile, and New Zealand. On the local scene, Fonterra recently formed an alliance with Nestlé, called Dairy Partners Americas, which will set several JVs in North, Central and South America.

2.3.4.3 Knowledge agreements

Knowledge agreements range from the simple sale of technology to licensing and franchising agreements, and it may represent the only alternative when trade and overseas investment are restricted/banned.

Knowledge agreements advantages are several as they involve minimal capital expenditure - if compared with the other servicing modes - they also represent a diversified source of income especially if technologies or managerial skills are under-utilised. On the other hand knowledge agreements also imply risks, especially those associated with the lack of control that the licensor has over the licensee, and the possibility that the licensee eventually grows to rival the licensor (Enderwick & Akoorie, 1996)

Although agricultural co-operatives and agricultural/horticultural companies in general have not been traditionally engaged in knowledge agreements, being mostly a service mode used by high-cost technology companies (with huge R&D budgets), and also by fast food multinational companies, the development and licensing of new products and/or technologies represent an attractive alternative that agricultural co-operatives and IOFs are increasingly considering.

2.3.4.4 International alliances

Co-operatives can form international alliances either with foreign co-operatives (international co-operative alliances), or with foreign IOF. The alliance may be constructed either as an agreement to co-operate within specific areas (marketing, production, R&D) or it may be constructed as a mutually owned enterprise covering all operations within one specific sector (Normark, 1996).

'Increasingly, global companies are forming strategic alliances... Globalisation mandates alliances, makes them absolutely essential to strategy' (Omaha 1990, p. 482).

Strategic alliances has been found to be complex organizational processes, with issues of synergies (principal argument for forming an alliance), trust between the alliance partners, competencies, language barriers and mutual adjustment all being relevant factors when exploring the possibilities for success (Normark, 1996).

Co-operative alliances may be used as a tool or previous step for the formation of transnational co-operatives. The alliance should be regarded as a change process where the partners incrementally strengthen their links between each other. The co-operative alliance might imply a possibility for international expansion without the need of enormous additional capital, so it would be a realistic and effective way of overcoming the internationalisation 'financial problem' (Normark, 1996).

2.3.4.5 Transnational co-operatives

The transnational co-operative is maybe the most 'extreme' of all the forms of co-operative internationalisation, but it may also be a very good alternative as will be seen later. However, the concept of transnational co-operation inevitably raises the question of member unity, over country borders, different languages, and different cultures (Normark, 1996).

The Federation of Danish Co-operatives (2000) defined a transnational co-operative as a co-operative that has: members in two or more countries, where members are equal as regards to rights and obligations, and where members have a common commercial goal applicable irrespective of nationality and place of residence.

Transnational co-operatives are the results of either national co-operatives admitting members from foreign countries or mergers between co-operatives in different countries, although intermediate forms also exist. Intermediate forms of transnational co-operatives include co-

operatives with gradually affiliated foreign members, co-operatives with foreign supplier without influence and obligations, and co-operatives with foreign supplier without influence and obligations.

Dutch co-operative Aalsmer, the world largest auction hall for cut flowers and plants, with a turnover of approximately 45 per cent of world flower production, is a case worthy of study. The co-operative has “full members” in Holland (96%), Germany (1%) and Belgium (3%), and “special suppliers” in Israel, Kenya and Ecuador, besides receiving deliveries of “normal suppliers” from large parts of the world. Aalsmer’s full members have complete delivery obligations, while suppliers range from suppliers with some degree of influence and full delivery obligations to suppliers loosely affiliated to the co-operative (Federation of Danish Co-operatives, 2000).

The identified barriers to the organization of transnational co-operatives are: 1) Cultural barriers (language, traditions), 2) Lack of specific co-operative legislation, 3) Absence of an international statute for co-operatives, 4) Differences in national legislation, 5) Competition rules and regulation competition, 6) Obstacles to trade, and 7) others, such as currency transformations or taxation difficulties (Federation of Danish Co-operatives, 2000).

According to this study, the success factors for the organization of transnational co-operatives are:

- (1) Members of the co-operatives must have joint and acknowledged interests
- (2) Agreement and support of co-operatives goals
- (3) Agreement on strategies and measures of structural policy
- (4) There must be a synergy effect
- (5) The Choice of transnational co-op as a form of internationalisation must be based on purely commercial considerations
- (6) Equality among members
- (7) Common culture and language
- (8) Co-operative traditions must be relatively uniform
- (9) Production conditions of members must be uniform
- (10) Agricultural and production structure must be uniform

(11) Access to relevant information

Joint co-operative ventures, or cross-border mergers between co-operatives constitutes feasible alternatives for internationalisation and size increase, especially in Europe where the blurring of national borders into the single European Market has become a reality (Verheijen & Heijbroek, 1994).

2.3.5 Remaining challenges and opportunities in internationalisation

Large co-operatives, have both the necessary volume and economies of scale to supply large retail accounts or to form partnerships with other firms (even IOFs) that can assist with marketing and add value to farm commodities.

According to Hughes (1996) the key strategic change or prerequisite to supply these large multinational retailers, is the recognition by co-operatives that they make consumer goods, and the consequent change to a product-oriented focus. For too long, he states, farmers and co-operatives have been production-oriented, and not aware of consumer wants and needs, and this cannot continue.

Also a shift from defensive to offensive strategies is mandatory if co-operatives are going to compete in international markets. Egerstrom (1996) cited the successful example of a Dutch potato co-operative, Avebe, which started pooling resources for traditional defensive purposes, but as a response to private factories price-setting practices, shifted to an offensive strategy, buying and taking over the factories.

When commenting on the future of large dairy and meat Danish co-operatives, Strandskov (1996) stated that they inevitably would have to develop expensive product brands, acquire foreign companies, or even found new ones, with the associated enormous investment required. For that purpose regional co-operatives would need first to merge.

Because of current changes affecting the European Union, it is there where most of the examples of co-operatives currently on internationalisation process can be found, and it is most likely, that further changes will be seen. In that atmosphere, Grosskopf (1996) sees two possible developments. They are the emergence of European co-operatives, and the emergence of holding companies, with large national, or regional co-operatives as members. These 'continental co-operatives' could be easily the next generation of co-operatives, but this has yet to be seen.

Constantly creating local and regional niches in the food system, which co-operatives may be uniquely qualified to fill, is the logical response to globalisation pressures that co-operatives should follow, according to Seipel & Heffernan (1997). They argue that co-operatives can play a role in this alternative food distribution system, by using their marketing infrastructure to re-establish direct links between food producers and consumers, alleviating concerns over food safety and quality.

Just as an aside, it is interesting to state that farmers' anti-globalisation movements, and therefore anti-co-operatives internationalisation, are also a force currently pushing in different parts of the world. In fact it is a force with very good media coverage. So for example in Germany, local farmers supported by local governments and the Green party, are using 'buy from your neighbours' campaigns to point out that agricultural products from the region are healthier, tastier, fresher, and environmentally-friendlier than foreign products (Grosskopf, 1996).

2.3.6 Potential conflicts

Internal conflicts may come from several sources. It may come from members seeing their co-operatives undergoing rapid changes, and they may not understand or appreciate these changes. Conflicts may be short or long-term conflicts. Van Dijk (1996) advises as a possible solution to avoid conflicts, that managers and farmer-Directors bring in consultants to help formulate and evaluate business strategy.

Normark (1996) states that proposal of strategic changes are often evaluated from the viewpoint of effectiveness within the co-operative, without paying much attention to the member-perspective. Is the proposed change positive not only for the co-operative itself, but also for its members? Changes proposals that are successfully created in a way that balances both the user's interests with the business logic are important for the long run of the co-operative.

In't Veld (1996) stated that values should not be isolated from a co-operative business as they are the foundations of the co-operative form. So when co-operatives are growing in size and scope, these values need to be re-examined. He argues that values may be sensitive to increases in scale, size, and there might be a point where fundamental values are at risk of crumbling away. *'Member orientation – the true touchstone of the co-operative identity – has tended to become increasingly mixed with profit orientation'* (Bager, 1997, p. 12). The question may be, is that wrong?

Salaberría (1997) brings out the example of an acquisition of a foreign company, or even the establishment of a new one, where efforts and investments deriving from the co-operative members are not reinvested at home, but take the form of a non-cooperative enterprise, creating employment outside its own territorial boundaries. Even though the ultimate aim is the members' benefit, there is no doubt that a certain contradiction exists, as well as a risk.

In't Veld (1996) in turn targets the relationships between values and the co-operative scale of operations, and the potential existence of a point of scale where these co-operative values cease to exist, raising interesting questions, such as: How far can a co-operative go? Where is the danger in the relationship between values and the co-operative business arrangements? He argues that major risks exist in co-operatives that are market-oriented and with capacity goals, where the risk in depersonalising members' relationships is high, and the possibility of ending the co-operative may not be far.

Co-operatives must balance the interests of members with the need to compete in a dynamic and competitive marketplace through globally focused strategies, which is in turn essential to the interest of members (USDA, 1997). Kyriakopoulos (2000) argues that many aspects of the

market orientation restructuring of co-operatives, which has become necessary in order to compete in the current business environment remain dark, especially those associated with the integration of co-operative firms and members.

“Strategic policies such as scaling up, internationalisation, or vertical integration, must be judged against the aims of the co-operatives members.... That sounds simple, but it is hardly the case” (Van Dijk, 1996, p. 176)”.

An interesting concept to highlight at this stage is that of the ‘co-operative life cycle’ proposed among others by Harte (1997), who argues that not all dissolutions of co-operatives should be regarded as failures, and in fact may be the appropriate movement when competitive market conditions have been reached.

2.3.7 Case study research

Dobson (1990) in his analysis of the former New Zealand Dairy Board (NZDB) competitive strategy, through the use of scenario analysis technique, found that the NZDB aim of becoming a multinational food company would work effectively if certain assumptions made by NZDB officials were correct. According to the author, some possible problems regarding research and development, and eventual lost of statutory authority remained unsolved. Anyway early moves made by the NZDB would make it a strong competitor in international markets. Time has apparently confirmed that view, but new questions have arisen now with the formation of Fonterra.

By the time the aforementioned study was undertaken, 10 years ago, the NZDB had already subsidiaries and associated companies in 25 countries. The internationalisation strategy generally followed by the NZDB fits with the Internationalisation Process model and its gradual-steps nature elaborated by Swedish researchers (Johanson & Vahlme, 1977). In short, the NZDB initially works through an agent. Then the NZDB forms a joint venture with the agent in order to expand sales, and finally ends with the acquisition of the joint venture partner and establishment of a subsidiary. This process would permit the NZDB risk control.

It is also questionable if this same internationalisation strategy is being or will be followed by Fonterra (e.g. Fonterra's alliance with Nestlé in the Americas).

Another case study where the NZDB was the main focus of attention is the study performed by Schroder et al. (1993) "Cooperatives, Statutory Marketing Organizations, and global business strategy", citing examples of globalisation strategies used by Producer Marketing Organizations (PMO), discussing the barriers that must be overcome, and with a case study, show how a PMO, the New Zealand Dairy Board (NZDB), can successfully overcome those barriers. The study is interesting from several points of view, first because it covers the topic of internationalisation of agricultural co-operatives, also because it has a very simple form of presenting the internationalisation barriers and forms to overcome them, and finally because it studies in depth the NZDB. The strategic analysis is probably the weakest part of the study.

Although not properly a case study research, Mauget & Declerck (1996) studied EC agricultural co-operatives' behaviour and performance on the period 1990-1991. Related to internationalisation they described the remarkable expansion into foreign markets of Danish meat processors co-operatives. Through a complex network of partnerships, Danish Crown, Steff Houlberg and others built processing plants, and successfully targeted foreign markets. The acquisition of foreign companies to process products abroad was the strategy successfully followed by Danish dairy cooperative MD Foods in the Middle East, Irish dairy co-operatives in the U.K. and the U.S. (Avonmore, Waterford, Golden Ave, and Kerry). Especially interesting was the success of Dutch dairy co-operative Campina-Melkunie, in raising funds from its members by issuing members participation certificates (US\$200 million) and acquiring a Belgian dairy company, Comelco.

As a failure case of internationalisation the experience of a French dairy Coop, ULN, was analyzed. ULN acquired companies in Belgium, Spain and the U.S. According to Mauget & Declerck (1996) ULN's strategy was a disaster, as the Cooperative did not succeed in getting the necessary capital from its members. As a result ULN had to borrow, and by 1992 when bankers refused to renegotiate the debt, a holding formed by bankers and French non-cooperative dairy firm Bongrain acquired ULN's processing units. The co-operative ended up managing only milk collection.

The Basque Mondragon Co-operative Corporation (MCC) has been the centre of several studies that have tried to understand the reasons behind its successful growth without losing its co-operative character (Hanna, Ridnour, & Meadow, 1992; Huet, 2001; Kohler, 2002). Internationalisation is the main growth strategy of the MCC with establishment of foreign subsidiaries, acquisitions, JV, and international alliances being every-day news, consolidating a business of US\$ 5 billions in revenues. However recent trends followed by the MCC has also raised some criticisms regarding its loyalty to the co-operative principles, even within its lines.

Founded in 1956, the MCC now groups about 200 co-operatives from three divisions: finance, industry, and distribution, the last one constituting a vertically integrated system of agricultural and retail enterprises (including the largest retail chain in Spain with sales of US\$ 2.6 billions). In 1990 the MCC became a corporation, with centralised management, setting up production plants in Egypt, Morocco, Mexico, Argentina, Thailand, and China. MCC has also set up many international JVs with capitalist partners, employing around one-third of non-members workers, considerably above the MCC commitment (Huet, 2001).

Seipel & Heffernan (1997) studied three American co-operatives that according to them have responded to the globalisation challenge. The co-operative studied are Land O'Lakes, Harvest States Cooperative, and Farmland Industries, Land O'Lakes international activities include feed manufacturing in Poland, and a range of technical assistance and training activities in rapid-growth markets such as Central and Eastern Europe, and the former Soviet Union. Harvest States participates with a transnational grain corporation in a JV established to export feed grain. Harvest States is also a member of a consortium of U.S., Dutch, Swedish, French and German co-operatives. Farmland Industries made an aggressive move by purchasing a transnational Swiss-based grain-trading firm, with offices in Switzerland, Germany, Argentina, France, and the U.S.

Ketilson (1997) in a study of the Canadian co-operative Saskatchewan Wheat Pool, which converted itself to a publicly-traded co-operative, reviews the democratic structures and process of the Saskatchewan Pool that are necessary in order to remain true to its roots,

especially when considering that the co-operative adopted a model that introduces outside investors. The key points reviewed are the democratic structures and the various democratic processes in place, such as volunteer activities, survey of members, member education, and participation of members in decision making.

The Federation of Danish Co-operatives (2000), on its study "Perspectives for admission of members abroad and cross border mergers" reviewed several European agricultural co-operatives in the process of internationalisation, focusing in the Transnational Co-operative form. The study is mainly descriptive, and covers examples (case studies), barriers to overcome, obstacles, legislation issues, success factors, and alternative organizational models for transnational co-operatives establishment. Eight case studies of European Transnational agricultural co-operatives were undertaken in this study (see Table 7).

Extremely interesting is the case of Aalsmeer, the world's largest flower auction (turnover of approximately 45% of world flower production) with members in Holland, Belgium and Germany, and with suppliers in Israel, Kenya and Ecuador divided in different categories, ranging from suppliers loosely affiliated to suppliers with full delivery obligations and some degree of influence.

Also remarkable, because of the operations scale (co-operative receiving 7 billion kg of milk), turnover size (36,000 mill DKK) and the truly multinational nature of its members (almost 50% Danish and 50% Swedish) is the case of the recently formed Arla Foods. The co-operative international activities include - among other things - international sales offices and production abroad (i.e. dairy operations in the U.K.).

Table 7: European examples of transnational co-operatives, 1998.

	Activity	Turnover	Members: number and composition
Milchunion Hocheifel	Dairy	573 mill DM	3,050 79% Germany, 13% Belgium, 8% Luxemburg
COVAS	Sugar	80 mill NLG	3,000 97% Holland, 2% Germany, 1% Belgium
Aalsmeer	Flower auction	2,959 mill NLG	3,500 96% Holland, 3% Belgium, 1% Germany
AVEBE	Potato starch	1,603 mill NLG	5,600 68% Holland, 32% Germany
Arla Foods	Dairy	36,000 mill DKK	17,600 54% Denmark, 46% Sweden

Source: Federation of Danish Co-operatives (2000).

CHAPTER THREE: METHODOLOGY

3.1 Research method

The purpose of this research project is to describe and explain how agricultural co-operatives, and co-operative hybrids, can internationalise their business while at the same time remaining close to their members, overcoming or avoiding the internal conflicts that may arise because of the chosen internationalisation strategy and structure. For that purpose qualitative research is the selected strategy.

Leedy & Ormrod (2001) argue that qualitative research often starts with a loosely defined research problem, and as the study progresses the researcher gains better understanding of the researched phenomenon, being increasingly able to ask specific questions. Therefore the qualitative study evolves over the course of the investigation, as has been the case in this research project.

Case study is one of several methodologies used for doing research, being more suited for answering 'why' and 'how' questions, as is the case in the main research question of this study. Case study is also the preferred method for examining contemporary events (Yin, 1994). Therefore as a consequence of the mentioned reasons, qualitative research using case studies is the selected methodology for this research.

3.2 Research design

The research method literature suggests that there are three types of case study research: descriptive, explanatory, and exploratory (Yin, 1994; Leedy & Ormrod, 2001). This case study was both exploratory and descriptive, as it explored the reasonably unknown territory of co-operatives internationalisation, and described their internationalisation process, as well as the mechanisms and structures utilised by the studied organisations in order to remain close to its members throughout the mentioned process.

This research consists of a multiple case study, using as the unit of analysis two New Zealand producer organisations of the co-operative type, one of them is a pure co-operative and the other one is what can be called a co-operative hybrid. The two cases are from different areas,

have different sizes and characteristics and are at different stages in their internationalisation process.

3.2.1 Study protocol

Following Yin's (1994) guidelines for undertaking case study research, a case study protocol was developed, which consists of the following parts:

I. Procedures

- Review of co-operative preliminary information (annual reports, media covering)
- Determination of people/stakeholders to be interviewed
- Development of a case study database:
 - Original data or evidence (tapes and questionnaires)
 - Elaborated data
 - Secondary data (Articles, reports)

II. Questions

- Semi-structured interviews (45 minutes to 1 hour of length), using open-ended questions.

III. Analysis plan and report

A. Individual case studies

- Descriptive information
- Analysis
- Outline of individual draft reports

- Revision by key informants
- Final individual case study reports

B. Cross-case analysis

- Descriptive information
- Analysis
- Cross-case report

3.2.2 Issues of research quality

One of the major concerns on case studies is related to the lack of rigor. To ensure quality of the case study design, special emphasis was put into constructing validity (construct validity and external validity), and reliability (Yin, 1994).

As recommended by Yin (1994) the following tactics were used in order to ensure the quality of the research:

- Use of multiple sources of evidence when collecting data (different Directors, members, company reports, and media articles), as these help to overcome the traditional limitations or concerns about case studies.
- Submission of draft case study reports to key informants (one on each case).
- Use of replication in the two case studies.
- Use of a case study protocol.
- Development of a case study database

3.2.3 Ethical considerations

As Berg (1998, p.31) stated: “*Social researchers must ensure the rights, privacy and welfare of the people and communities that form the focus of their studies*”, thus research ethics was

an extremely important point in this research and precautions were taken to ensure the participants confidentiality and anonymity when corresponding.

It was made clear to the participants that the collected information will be kept confidential and that individual details will not be revealed at any time. When specific quotations were used in the final report, permission was asked from the subject involved.

Information sheets, describing the research and its purpose were given to every participant of the research (interviewees). The name, address, and phone number of the researcher were also included (Appendix I).

Also, consent forms, with the nature of the project and the rights of participants were handed to all participants and asked to sign, before interviews were undertaken. The interviewee was given the right to withdraw from the research at any time (Appendix II).

3.3 Selection of participants

As it was mentioned, multiple case study was the selected research design. For that purpose two New Zealand agricultural organisations of the co-operative type were analysed as case studies.

Even though it can be argued that internationalisation does not really constitute a strategic option for New Zealand agricultural co-operatives and due to the reduced size of the local market, it represents more of a necessity, it is precisely that factor that makes New Zealand co-operatives extremely interesting to study, as they never had the option of concentrating in the local market and being local co-operatives, and internationalisation, even in its most primitive form (exporting) has always been a reality, converting some of these co-operatives into highly efficient international organisations.

In the process of contacting participants for the case studies, one of the answers received when asked to participate in a co-operative internationalisation study was that even though the study sounded interesting, potential participants were not into internationalisation of their co-operatives (maybe misunderstanding internationalisation for globalisation), proving the confusion about the terminology that reigns on the sector and even the literature (see Subchapter 2.3).

The two co-operatives to be analysed as case studies for this research are:

- Fonterra Co-operative group
- Zespri Group Ltd.

Of the two selected case studies one is a pure co-operative, Fonterra Co-operative Group, and the other one, Zespri Group Ltd., is a producer-owned corporation, a co-operative hybrid for the purposes of this research. The selected companies were contacted during May 2002.

The selection of the case studies was based on the overall importance in their respective sector, and the fact that they have different sizes, come from different backgrounds, are at different stages in their internationalisation process, and have adopted different structures to face internationalisation. It is the researcher's belief that interesting gains can be obtained from the cross comparison.

3.4 Data collection

For each case study, data was collected from primary and secondary sources. Primary data was obtained from interviews with representatives of the co-operative including the chairman, Directors of the Board, senior executives (CEO) and various management staff.

Interviews were semi-structured, with open-ended questions, with the main purpose of getting a better understanding of the co-operative internationalisation strategy and the reasons and

implications behind it. Also, through the interviews the researcher tried to gain understanding on how the co-operative executive management staff and governors (Directors of the Board and CEO) managed the internationalisation process to ensure that no conflicts with the members' interests were generated or conflicts were overcome. Interviews were tape-recorded, with the authorisation of the participants, with copies being held at Massey University.

A total of 13 people were interviewed in Fonterra, and 10 in the case of Zespri. A draft list of key people to be interviewed, for the purposes of this project, was outlined, and following recommendations of representatives of the companies and availability of the potential participants a final list was made. Despite both organisations are different in size and structure, a similar pattern was followed (see table 8).

Interviews were pre-arranged by telephone and email, and undertaken from July-September 2002. The length of the interviews was approximately 45 to 60 minutes each, and the location depended on the individual interviewees' preferences.

Table 8: Case studies' interview structure

Fonterra	Zespri
Chairman	Chairman
Deputy chairman	
CEO	CEO
Directors (2)	Directors (2)
Chairman of the Council	Chairman of KGI (representative independent body)
former Chairman of the Council	
Councillors (3)	
Corporate Communications Director	Industry Relations Manager
R&D Manager (FRC General Resources Manager)	R&D Manager (Zespri Innovation General manager)
	Global Marketing Manager
Operations Manager Shareholder Services	Grower Liaisons (2)

In order to identify the most significant questions to be used in the interviews, an in-depth literature review was performed. Because very little information was available on the topic of co-operative's internationalisation, the specific areas to be covered in the interviews were difficult to identify, and a better definition of the themes and categories was gained as the interviews proceed.

Secondary data included publicly available information such as academic articles, company reports, newspaper and magazine articles and the Internet. One of the main tasks in this aspect was having to make a continuous distinction between relevant and non-relevant information. For that purpose the researcher performed a continuous process of collection, classification and analysis of the data.

3.4.1 Semi-structured interviews construction

The aim with the semi-structured interviews was to gain a better understanding of the structures and mechanism undertaken to ensure the optimum maximisation of the internationalisation benefits while not distancing from members or generating conflicts with their interests. Implications of the chosen strategies were analysed and special interest was placed on understanding the mechanisms and structures undertaken by the co-operatives, to avoid/overcome conflicts.

Tolich & Davidson (1999) argued that qualitative research is an iterative and reflexive process, and questions are most likely to change as interviews happen, so each interview should be different from the previous one.

Semi-structured interview guidelines were used because of the differences in the representatives' backgrounds, functions performed in the co-operative and others. Therefore questionnaires were not exactly the same, and were only used as a checklist to be sure that all issues were covered in the interviews. A draft of the interviews and the topics to be covered were sent to the participants before the interview so they were aware and prepared. Following

Tolich & Davidson (1999) guidelines, interviews were divided into three sections: introductory questions, theme questions and clarification questions.

Theme questions also evolved during the interviewing process, but in general they covered the following areas: co-operative internationalisation strategy, implications for members of the different strategies (FDI, alliances, transnational co-operatives), mechanisms and structures in place (e.g. communication channels, education of members, education of Directors, performing of studies, external consulting), and the co-operative's future.

3.5 Data analysis procedures

Interviews were tape-recorded and latter fully transcribed. Information was then coded and analysed to identify key factors and conceptual themes (categories), so as to condense the information. All raw data (interviews), and analysed data (codified information) were kept in independent files.

Finally, once single case analysis were finished, a cross case analysis was performed, comparing similarities and differences found over the two case studies. Results of the single cases and of the cross case analysis were compared against the literature review findings.

3.5.1 Development of a model of internationalisation of agricultural co-operatives

While analysing the case studies included in this study it was found necessary to organize all the different Foreign Market Service Modes¹ (FMSM) used by the two studied agricultural co-operatives in their internationalisation process within a model.

¹ Although the specialised literature tends to use the term foreign market entry mode, the term Foreign Market Service Mode (FMSM) was used, as this was considered to be more comprehensive.

The Federation of Danish Co-operatives (2000) defined 'international co-operative' as any co-operative that have initiated one or more of the following forms of internationalisation: export, alliances, direct investment and/or organisation of a transnational co-operative. The model, although useful, proved to be basic and limited on its extension when categorising certain FMSM such as Joint Ventures (JVs) and licensing for example.

Pan & Tse (2000) developed a hierarchical model of entry market modes, which groups them into equity-based and non-equity based entry modes. Within the equity-based ones they distinguished wholly owned operations and equity JVs, while within the non-equity based ones they distinguished exports and contractual agreements like licensing and R&D contracts.

Pan & Tse's model, although very comprehensive and useful for differentiating FDI, JVs and wholly owned subsidiaries, is mainly focused to IOF/corporate firms and therefore has limited application for agricultural co-operatives especially when trying to classify certain FMSM like external sourcing (or third party sourcing as it is also known). Also the model does not take into consideration the concept of transnational co-operative or the internationalisation of shareholding.

Therefore and guided by the mentioned models, a new model was conceptualised (Figure 2). In this new model six main FMSM can be identified: exports, FDI, external sourcing, knowledge agreements, strategic alliances and formation of transnational co-operatives. Some of the main FMSM can in turn be subdivided into sub-modes like for example FDI into JVs and wholly owned subsidiary.

The inclusion of transnational co-operatives as a FMSM responds to the implications that international shareholding has for agricultural co-operatives and although it can be correctly argued that it cannot be considered as a FMSM because at the moment of establishing a transnational co-operative the foreign market becomes local, the formation of a transnational co-operative would be last step in the internationalisation of an agricultural co-operative.

The new model, although of limited empirical base, proved useful for organising the vast array of FMSM used by the two studied co-operatives and of other found on the literature review.

3.6 Presentation of results

Individual case study reports as well as a cross-case study report are included. The study ends with the conclusions, final answers to the original research question and sub-questions, and areas for further research.

The audience the report is directed to consist of co-operative members and leaders, specialist researchers, and general audience.

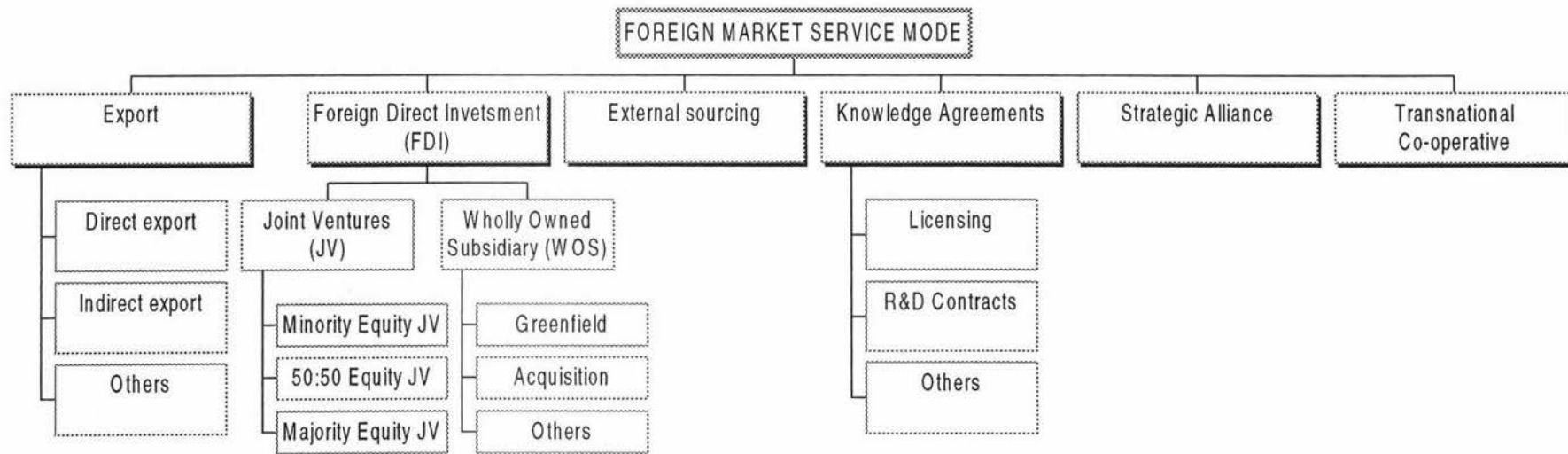
3.7 Summary

This research analyses in depth the internationalisation process of a co-operative through the use of two case studies in order to determine how can agricultural co-operatives manage the internationalisation of their businesses without distancing itself from its members, and overcoming or avoiding potential conflicts that could arise.

Multiple case study is the selected methodology and data was obtained from primary and secondary sources. Information from primary sources was obtained from interviews with co-operative representatives. Secondary sources included academic literature, company reports, newspaper and magazine articles and the Internet.

Information is analysed, individual case studies are outlined and finally a cross-case study comparison is performed.

Figure 2: Model of FMSM used by international agricultural co-operatives



CHAPTER FOUR: FONTERRA CO-OPERATIVE GROUP CASE STUDY

4.1 Company overview

Fonterra Co-operative Group (Fonterra) is a truly global company co-operatively owned by over 13,000 New Zealand dairy farmers. Fonterra has 20,000 employees, over 90 subsidiary and associated companies worldwide, annual 2001-2002 revenues of US\$6.5 billion (NZ\$13.9 billion), assets of US\$5.8 billion (NZ\$ 12 billion) and shareholders' equity of US\$2.5 billion (NZ\$4.5 billion), generating over 20% of New Zealand's export receipts and seven per cent of its Gross Domestic Product, making it New Zealand's largest company.

In global terms Fonterra is the world's largest exporter of dairy products, responsible for about a third of international dairy trade, with the United States being its largest single market by revenue and Asia its largest export region. The New Zealand market, although it consumes only 5% of its production, contributes around 12% of its revenues. Fonterra operates through two main subsidiaries: the ingredients business NZMP and the consumer and food service business, New Zealand Milk, in 140 countries, having 29 manufacturing sites in New Zealand and 35 in other countries.

When compared against the world's top dairy companies by revenues, Fonterra was ranked in fourth position for 2001/2002, ranking second among dairy co-operatives behind Dairy Farmers of America (Rabobank, 2002).

Fonterra is the result of the merger of the New Zealand Dairy Group, Kiwi Co-operative Dairies and the New Zealand Dairy Board (NZDB) in October 2001, which saw the simultaneous removal of the NZDB's statutory exporting monopoly and therefore the deregulation of the NZ dairy industry.

Since its formation Fonterra has continued an aggressive programme of acquisitions, joint ventures and alliances with other dairy and food businesses worldwide that have seen Fonterra increase its international reach considerably. Major deals were completed in Europe (JV with Arla Foods in the UK), the Americas (alliance with Nestlé), Asia (JV with Britannia

Industries in India) and in Australia (merger of Fonterra's New Zealand and Australian foods businesses to form AFHL).

The past 13 months, starting with the supportive shareholders vote for Fonterra on June 2001, the finalisation of the merger on October 2001 and the presentation of its first annual report in July 2002, has been one of record achievements for Fonterra and its farmer-shareholders, including record revenues of NZ\$13.9 billion, record processing of New Zealand milk of 1.1 billion kgms, and a record payout to farmer-shareholders of \$5.33 per kgms.

On the other side it has also been a first year tainted with milk collection problems, low shareholders turnout at voting and meetings in the second part of the year, the resignation of Mike Smith, one of its appointed Directors due to 'governance problems' and a declared \$50 million loss on its turnover, as a result of the company's decision to stick with its commitment of giving farmer-shareholders a record payout (NZ\$5.9 billion) while facing an end of season with falling international prices.

In summary, it has been a year of mixed feelings as the Shareholders' Council notes in its 2002 Annual Report to shareholders, stating that although significant progress has been achieved, the performance of the company in a number of key areas has been disappointing.

As Fonterra heads into its second year of life, several challenges await for the company, now under the leadership of a new Chairman after the stepping aside of Chairman John Roadley in September 2002, in order to perform to its potential and shareholders' expectations as well as to re-enchanted and bring disillusioned farmers back in support. Also important, although in the longer term, the chosen internationalisation strategy has implications that have to be carefully addressed in order to avoid potential conflicts that might otherwise arise.

4.2. History²

In June 2001, 84% of the farmers of the two biggest New Zealand dairy co-operatives, the New Zealand Dairy Group and Kiwi Co-operative Dairies, voted supportively to merge their operations and together with the New Zealand Dairy Board (NZDB) form Fonterra Co-operative Group³.

By October 2001 the company was officially formed, the official name announced and the people to lead the company been named. The merger not only saw the birth of one of the five biggest dairy companies in the world, but also the removal of the NZDB's statutory exporting monopoly powers and therefore the deregulation of the New Zealand dairy industry.

The formation of Fonterra is the latest step in the process of consolidation and rationalisation of the New Zealand dairy companies that has caused a reduction in the number of dairy co-operatives from 180 in 1960, to 14 in 1994, and finally three in 2002: Fonterra, Westland and Tatua.

The New Zealand dairy industry beginnings are rooted in the 1870s, with the first dairy co-operative factory being set up in New Zealand in 1871⁴. With the expansion of dairying the number of factories increased greatly with the proportion of co-operative factories increasing relative to proprietary ones. Historically the industry was established along local lines, with even the smallest communities having their own dairy company.

The New Zealand government strongly encouraged the formation of butter and cheese factories from 1880 onwards, and as a consequence, co-operative dairy companies sprang up all over the country. The Dairy Industry Act 1908 consolidated all previous legislation and also provided for the registration of co-operatives.

In 1923 the government established the Dairy Produce Export Board, popularly know as the 'Dairy Board' to act as the single export seller. The New Zealand Dairy Board (NZDB) was

² For a deeper look at the history of the New Zealand dairy industry see for example Yerex (1989), Enderwick & Akoorie (1996) and Dawber (2002).

³ The temporary name of Fonterra was GlobalCo.

⁴ The first co-operative dairy factory was the Otago Peninsula Co-operative Cheese Factory (Dawber, 2002).

formally established in 1961 and had monopoly rights over the purchasing and marketing of all dairy products exported from New Zealand.

The exporting nature of the New Zealand dairy industry goes back to its very beginnings with the introduction of cheese and butter-making techniques and the export of refrigerated cargoes following the first shipment of frozen lamb in 1882 (Enderwick & Akoorie, 1996). By 1909 New Zealand was producing 51 million pounds of butter and exporting half of it, mainly to the UK, Australia and South Africa; cheese production was 37 million pounds, of which more than 34 million was exported.

Since the 1880s, when the first frozen shipments were sent to Europe to the early 1970s, New Zealand dairy companies sold almost all their production to the United Kingdom, which meant that when the UK signalled its intention of joining the European Union in 1973, New Zealand dairy companies found themselves at a crossroads. As a response to this challenge the NZDB initiated a strategy of market diversification that saw the exports of New Zealand dairy products increase drastically.

In 1994, the commitments of the agreement on dairy products made at the Uruguay round of the negotiations of the World Trade Organisation (WTO, in those days the GATT) meant, theoretically at least, an expansion of the accessible dairy market from NZ\$83 billion to NZ\$147 billion.

The question of reforming the structure of the NZDB surfaced with the advent of economic liberalisation in 1984 and deregulation of other sectors of the economy. The formation of Fonterra and the incorporation of the NZDB into its structure in 2001 marked the end of its 50-year history of control and marketing of the NZDB as the sole statutory authority for the export of New Zealand dairy products.

4.3 Environment

4.3.1 World dairy industry situation

According to Rabobank (2002), the most important changes and challenges driving the global dairy industry are:

- Growing demand for dairy products (world demand for dairy products is currently growing at 2% per annum)
- Increasing number of consumer requirements (e.g. low fat milk)
- Increasing power of customers (i.e. retailers)
- Concerns about the milk supply (e.g. such as additives)
- Changes in dairy policies (e.g. trade liberalisation)

World milk production in 2000 was 568 million tonnes. Of this, approximately 480 million tonnes (84%) is cow's milk with the balance being buffalo, goat and sheep milk. Buffalo's milk dominates in the domestic markets of Indian and Pakistan (Rabobank, 2001d).

One key aspect of the Rabobank report (2002) is that even though world dairy supply is increasing by around 1% per annum, world demand for dairy products is growing at 2% per annum, creating concerns among dairy companies about securing sufficient raw product (i.e. milk).

It has been stated that in general terms, dairy consumption, production and stock levels are the three factors that interact to set world prices (other factors that affect world prices are subsidies, especially export subsidies). Sale prices in the international dairy market are typically agreed three months ahead, resulting in a lag effect for commodity price movements.

On the other side of the scene, the increased power of the retailing sector, where major multinational supermarket chains are becoming increasingly powerful and concentrated (see table 9), represents further pressure for dairy companies that are forced to source these multinational customers globally and on a year-round basis.

Table 9: Top 10 retailers' global sales (Figures in US\$ billion, year 2000)

1. Wal-Mart Stores (US)	191	6. Albertson's	37
2. Carrefour (France)	60	7. Rewe	37
3. Kroger (US)	49	8. Auchan	34
4. Ahold (Netherlands)	48	9. Leclerc	33
5. Metro AG	45	10. Intermarche	32

Source: Rabobank (2001c)

The environment in which the international dairy trade is carried out is highly politicised, with export subsidisation and protection of the dairy industry being high, mainly in developed countries⁵. Only 5% of world dairy production is traded internationally, of which Fonterra dominates about a third.

Liberalisation of international dairy trade has started only recently following the first WTO agreement (1994). The upcoming WTO negotiations, included in the Doha Round, for a second dairy agreement will include all the issues of trade liberalisation, being key in terms of reducing export subsidies and ensuring greater market access, and therefore being key for Fonterra's interests.

According to Rabobank (2001d) most dairy trade in the last decade went from the high-income regions of the EU and Oceania to the low and middle-income regions of Asia and Latin America. Despite its big production levels, the role of North America on the world markets is limited as most of its production is consumed domestically.

Fonterra has to face protectionism when doing business overseas not only from local governments but also sometimes from local producer groups and companies that see in Fonterra, the largest exporter of dairy products, a serious threat to their business. In France, local producer associations backed by anti-globalisation groups expressed their concern over

⁵ In October 2002, the Global Dairy Alliance was inaugurated, bringing together non-subsidised dairy producers from Argentina, Australia, Brazil, Chile, New Zealand and Uruguay in order to promote trade liberalisation and subsidy reduction within the world dairy industry. The Alliance is headed by Fonterra's CEO, Craig Norgate.

Fonterra's growth in the world markets, stating that New Zealand farmers were leading a new colonialism through aggressive expansion at unsustainable low prices⁶.

An ongoing wave of mergers, acquisitions and alliances has characterised the world dairy industry in the last 5 years. Rabobank (2001c) reported that from January 1998 to April 2001, there were a total of 490 mergers and acquisitions in the dairy industry, giving an impressive figure of one merger or acquisitions every 2.5 days, ranging from the very small to the large and significant market transaction. According to Rabobank the wave of mergers and acquisitions was not expected to stop soon.

Co-operative dairy companies continue to play a vital role in the world dairy industry, with eight co-operatives included in the world's top 20 dairy companies (Table 10) and a third of all mergers, acquisitions and alliances that had taken place throughout the world since 1998 being initiated by co-operatives (Rabobank, 2001c).

To compete in the current international dairy markets "*dairy companies will increasingly be forced to improve efficiency, open new markets, try to gain larger market shares and greater market power, extend their brand portfolio, boost their innovative capacity, secure their long-term supply and gain better access to capital*" (Rabobank, 2001c, p.4).

4.3.2 Main competitors in world markets

In terms of dairy turnover the ranking among the world's top dairy companies (table 10) is led by the multinational Swiss-based Nestlé, with the recently formed Dean Foods Company, result of the merger in the US of Suiza Foods and Dean Foods, in the number 2 position. Fonterra is in the number 4 position and in the second position among dairy co-operatives behind Dairy Farmers of America (Rabobank, 2002).

⁶ According to Phil Turner, Fonterra Trade Policy Manager Europe present at the Annual Conference of French National Dairy Producers (Dairy Exporter, May 2002, p. 92).

Table 10: World's top 20 dairy companies (dairy sales in US\$ billions)

1. Nestlé	13.6	11. Arla Foods (c)	4.3
2. Dean Foods	8.7	12. Morinaga	4.2
3. Dairy Farmers of America (c)	7.9	13. Friesland Coberco DF (c)	3.8
4. Fonterra Co-operative Group (c)	6.5	14. Bongrain	3.6
5. Kraft Foods	6.3	15. Land O'Lakes (c)	3.6
6. Danone	6.2	16. Campina Melkunie (c)	3.5
7. Parmalat	5.6	17. Snow Brand	3.4
8. Unilever	5.0	18. Sodiaal (c)	2.5
9. Lactalis	4.9	19. National Dairy Holdings	2.3
10. Meiji Diaries	4.7	20. Nordmilch (c)	2.0

Source: Rabobank (2002).

Key: c = co-operative.

The situation has changed drastically since the same ranking was elaborated by Rabobank (2001c) one year ago, when Fonterra (in those days GlobalCo) was ranked 9th among the world top dairy companies with estimated revenues of US\$ 5 billion. Other important changes from last year ranking include the new Dean Foods climbing to the number 2 position, and the Japanese company Snow Brand falling sharply from the 7th to the 17th position due to contamination problems and miss-labelling scandals.

4.3.3 New Zealand dairy industry situation

An extremely interesting fact about the New Zealand dairy industry is that despite producing less than 2% of the world's dairy production, New Zealand has over 30% of the world's international dairy trade. In other words, it is an industry totally focused on exporting, with over 95% of the production being exported.

With a yearly production of over 1 billion kilograms of milksolids in a country of just over 3.5 million people, only 4% of New Zealand's milk production is consumed domestically. This has been the case since the dairy industry was established in New Zealand in the 1880's, with the introduction of cheese and butter-making techniques and export using refrigerated ships.

Because of the export nature of New Zealand's dairy industry, practically the totality is based on processed products like milk powder, butter and cheese. Most of the milk delivered to the factories is immediately stripped of its water content and then further processed. Therefore milk volumes are expressed in terms of kilograms of milk solids (kg ms), the milk fat and protein content of the milk, instead of litres or kilograms; the payout to farmers since 1993 has been expressed in that measure. Milk solids can be roughly converted into litres of milk using a multiplier of 12.

New Zealand Dairy farmers are reported to be the lowest-cost milk producers in the world. Their low housing and feed expenses associated with their relatively large pasture-based farms produce, for example, average costs that are half of those of an average US milk producer (IFCN, 2002). It must be noted that producers from countries like Uruguay, Brazil, Australia, India and Chile are increasingly getting close (see Appendix III). The International Farm Comparison Network (IFCN, 2002) identifies that New Zealand dairy farmers have the lowest cost of milk production in the world, although they warn, their profitability (average 10.7% ROI⁷), could be classified as 'uncomfortably low' in the competitive world dairy environment.

The New Zealand dairy industry and in fact the whole of New Zealand agriculture has the lowest levels of government support among the OECD countries. Reforms of the agricultural sector in 1984 together with the openness of the whole economy, measures popularly known as 'Rogernomics', saw the removal of all subsidies, which in turn are argued to be one of the reasons behind New Zealand primary industries' strength and therefore behind New Zealand dairy industry international efficiency.

On the other hand the New Zealand pasture-based farming system implies significant milk processing costs. Manufactured milk processing falls to near zero levels during the New Zealand winter months of June and July implying a sub-utilisation of the infrastructure in those months.

⁷ According to John Roadley, Fonterra Chairman of the Board, South Island Dairy Event, 26 June 2002.

Seasonal fluctuations, attributed mainly to the pasture-based nature of the industry, are very strong in New Zealand dairy farm production. Over 75% of all deliveries happen during the six months from September to February, and deliveries in June and July together amount to less than 0.5% of annual production. During the peak month of October, deliveries are almost 120 times higher than in the months of June, when pasture growth is minimal and farmers dry off (stop milking) their cows.

The relationship between the gain in production and the increase in manufacturing and storing costs, has not been deeply studied, although a study comparing manufactured milk processing costs for New Zealand and West Germany concluded that seasonality probably makes New Zealand less efficient than West Germany, but that is more than offset by greater efficiency in the farm sector which results in an overall competitive advantage for New Zealand (Dobson, 1990). The discussion is of particular interest now that Fonterra has introduced the peak notes mechanism, where farmers have to contribute with capital in relation to their supply curve.

Other New Zealand dairy industry's uniqueness lies on its proprietorship where all of the milk production is handled co-operatively and on its sharemilking system. Through the sharemilking system, 'sharemilkers' operate a farm for an agreed share of the farm income, as opposed to a set wage, involving 29%, 39% or 50/50 agreements. Sharemilking has traditionally been the first step to farm ownership in New Zealand (MAF, 1993).

Dairy production is not equally distributed in the country, as 85% of dairy farms and 79% of the total cows are located in the North Island, although the South Island is quickly developing and dairy farming has expanded 73% over the past five years, due among other things to a rapid increase in farm size of South Island farms (already 40% bigger than North Island farms on average), as well as to migration of farmers to the South, where land prices have been more attractive, converting sheep farms to more profitable dairy farms (LIC, 2001; Van Bakkum, 2001).

Dairy production has dramatically increased in New Zealand over the last two decades (Table 11), with total milk processed more than doubling since 1975. Due to economies of scale, the

total number of cows and average herd size has gone up with the current average size being 251, while total number of herds has gone down significantly (LIC, 2001).

Table 11: New Zealand dairy industry statistics, key figures.

Season	Milk processed (million Lts)	Milk solids processed (million kgs)	Herds	Total cows	Average herd size	Average kgms/cow	Average kgms/ha
1974/75	5,222	425	18,540	2,079,886	112	-	-
1979/80	5,997	506	16,506	2,045,808	124	-	-
1984/85	6,965	578	15,881	2,280,273	144	-	-
1989/90	6,868	572	14,595	2,313,822	159	-	-
1994/95	8,633	733	14,649	2,830,977	193	271	671
2000/01	12,322	1,046	13,892	3,485,883	251	310	825

Source: Livestock Improvement Corporation, LIC (2001)

4.3.4 Local dairy companies

Whilst Fonterra absorbed most of the former functions of the NZDB, there are exceptions such as Livestock Improvement Corporation and the so called 'industry good activates' (on-farm research, exotic disease control, environmental issues) administered by Dairy Insight and financed with a levy to all dairy farmers irrespective of their company/co-operative.

In terms of local competitors, Fonterra's only real market competitor in New Zealand is Dairy Foods, which has over 40% of the market. It is somehow ironic that Fonterra had to sell Dairy Foods when the merger took place as part of the conditions to satisfy competition concerns from the New Zealand Government.

In New Zealand there are today three co-operative dairy companies, Fonterra Co-operative Group, Tatua Co-operative Dairy and Westland, together with 16 very small registered milk-processing companies. Fonterra is by far New Zealand's largest dairy company (and in fact New Zealand's largest business) controlling about 95% of New Zealand milk supply, with the remaining two co-operatives controlling 2.7% of the milk supply in the case of Westland and 0.85% in the case of Tatua.

As New Zealand's dairy industry has just recently deregulated it is likely to expect in the next few years increasing competition in the milk processing sector from local individuals or groups of farmers setting up new processing firms, as well as large multinational firms such as Nestlé, Parmalat or Kraft entering the New Zealand market and competing for its highly-skilled and cost-efficient farmers as suppliers: *"It is possible, even probable that Fonterra will be faced with a declining share of the New Zealand milk supply, say, 75 to 80% compared to about 96% at present"* (Alan Frampton⁸, 54th Conference of Dairy Farmers, Palmerston North, 8 May 2002).

By producing mainly for domestic and/or speciality markets, Tatua and Westland have managed to have a very good performance and positive long terms perspectives. Both Tatua and Westland decided not to be part of the mega merger process.

When comparing these two co-operatives against Fonterra, despite the obvious differences in size and structure, other interesting differences arise. Tatua is a very small co-operative that has concentrated on added-value product development and finding niche markets appropriate to its size. Tatua has defined itself as a New Generation Co-operative (NGC). Westland can be described as a very efficient producer of high quality commodity products. It is appropriate to state, that although it is not possible to directly compare payouts due to the differences in size, both co-operatives, Tatua and Westland, out-paid Fonterra in the season 2001/2002 (Table 12).

Table 12: New Zealand dairy co-operatives payout to suppliers 2001-2002.

	Fonterra	Tatua	Westland
Payout (\$/kg ms) ⁹	5.30	6.80	5.43

Source: MAF website

⁸ Alan Frampton is the Chairman of Tatua Co-operative Dairy and has received several international awards in the dairy industry.

⁹ Fonterra and Westland used capital from reserves in their 2001-2002 milk payout.

Both, Westland and Tatua, are small co-operatives with Westland processing milk from 373 members and Tatua processing the milk from its 140 members. Westland is open to the incorporation of new members from within its region, but Tatua deliberately restricts its milk intake having a waiting list for new members, having accepted only 10 significant new suppliers in the last 15 years (Van Bekkum, 2001). Despite its small size, Tatua has its own laboratories and produce some 85 high value-added products. It has three divisions producing cream derivatives, spray-dried proteins and a range of hydrolysates and lactoferrin, having in the later sector a 20% world market share (Frampton, 2002).

4.4 Current situation

4.4.1 Mission statement and strategy

The first important thing to have clear and something that the company has repeated on several occasions, is that Fonterra has inherited the NZDB strategy, in other words Fonterra's strategy is still a continuation of what was set up in the 1998 Industry Strategy (based on what has been called the McKinsey Report), which Fonterra has finished reviewing in November 2002¹⁰.

The NZDB's mission Statement was: *"to be the world's leading marketer of dairy products"*. Fonterra's recently released (November 2002) Project Galileo defined Fonterra's mission statement as follows: *"to lead in dairy"*. So as it can be seen, even though there are slight differences, the fact is that Fonterra takes formal proprietorship of its predecessor's mission statement and strategy, based on seven strategic themes; therefore the mission statement and the strategy have not changed drastically.

Fonterra itself is a product of the NZDB strategy: *"The 1998 Industry strategy gave the industry clear direction. It drove the creation of Fonterra, as the very best structural option to pursue key growth opportunities. It envisaged the sort of alliances and JVs that we have only*

¹⁰ In November 2002 Fonterra released its strategy review, 'Project Galileo' (see Appendix IV).

recently been able to pursue” (Craig Norgate, Fonterra CEO, Dexcel Ruakura Dairy Farmers Conference, Hamilton, 15 May 2002).

Therefore, another important clarification to be made is that although the general perception could be that Fonterra has been implementing a very aggressive strategy of broadening the international reach of the company through various mergers and acquisitions, those were also set by the previous strategy and in fact by the previous organisation, the NZDB: *“There has been a rush of acquisitions and JVs since the formation of Fonterra, but what you will find is that they were all actually negotiated before Fonterra was even formed, they were simply announced later”* (Jim van Poel, Director of the Board, personal interview, July 2002).

In other words, pretty much the totality of the international deals sealed by Fonterra from October 2001 to July 2002, including the alliance with Nestlé in the Americas, were in the making before Fonterra was formed but announced when the company was formed. In fact the merger of the Australian and New Zealand consumer businesses operations and the creation of Australasian Food Holding Limited (AFHL), announced in July 2002, is the first major initiative generated entirely by the new company.

4.4.1.1 Adding value: NZDB’s and now Fonterra’s strategy

Fonterra’s value-added strategy consists of moving the business away from the commodity cycle as much as possible, investing strongly in added-value consumer and speciality products. By pursuing a value-added strategy the company should be able to increase the value of the company, increase the returns it pays to farmer-shareholders and also important, bring greater stability to those returns.

The NZDB’s value-added strategy is broken down to individual business units in charge of product groups such as cream products, milk powders, proteins, cheeses, etc, who in turn produce their own strategic and business plans for the future development of their business (Enderwick & Akoorie, 1996).

The counterpart of the value-added strategy is that as the company got involved in adding value, it got involved in specialty products and the associated R&D, as well as the associated marketing and brand development, all of them very expensive activities.

The tools by which the NZDB aimed to increase the exports of specialised or value-added products were to increase sales through foreign subsidiaries and the diversification of products and markets. Complementary strategies to these were to increase R&D, increase sales of specialised food ingredients and improvements of returns where import restrictions such as quotas impeded sales expansion.

It is important to state that independent of the value-added strategy that Fonterra (and previously the NZDB) has adopted, still up to 80% of the business continues to be based on commodities.

4.4.1.2 Strategy review¹¹

As already stated, Fonterra's strategy at this stage is still a continuation of what was set up out of the 1998 McKinsey Report as a strategy for the New Zealand Dairy Industry. The review of that strategy and the development of an organisational strategy (as opposed to national industry strategy) was named by the company Project Galileo, which was delivered in November 2002. Its most important points are outlined in Appendix IV.

At the same time that Project Galileo was underway, the Shareholders' Council had a committee looking at co-operative philosophy and core values of the company. This work although of a lower profile should have a strong impact over the company's strategy and also over the capital structure in terms of, for example, how close to the co-operative core business does the company's share (fair value share, FVS) needs to apply.

¹¹ As Project Galileo was released at a time that this study was in its final phase, it was not included.

Although Project Galileo was marketed by the company as a refresh of the on-going strategy, as a tuning up that should not theoretically imply drastic changes from the company's current direction, some queries arised in the media in terms of the impact of the new strategy given the active agenda of acquisitions, JVs and alliances that the company has maintained over its first year of life: *"Why is Fonterra making major decisions, like the Nestlé alliance, before it has an strategic plan in place? Will Fonterra need to raise more share capital in the future? Will Fonterra need outside share capital to achieve its growth goals?"*¹².

4.4.2 Business structure

As stated in its annual report, Fonterra Co-operative Group is a co-operative dairy company, in accordance with the New Zealand Co-operative Companies Act 1996. Fonterra is classified as a pure co-operative as its intention, mission statement and key objectives are clearly to serve its members fully; its members have the final say in all important decisions; its milk price payment is truly co-operative; and in its methods of financing take into account the interests of existing, new and exiting members (Rabobank 2001a).

Even though Fonterra's main subsidiaries, New Zealand Milk and NZMP, are both 100% owned by the co-operative and there is no external capital in them, the resemblances with evolved co-operatives models like the ones described by researchers such as Cook (1995) and Van Dijk (1996) arise (see literature review, subchapter 2.1.2), especially in terms of the financing mechanisms used (JVs and alliances) of its international web of subsidiaries, as well as on its very unique capital structure.

Finally it has to be stated that although Fonterra is a pure co-operative, on the international side it can be classified as a multinational company, but not a multinational co-operative (also know as transnational co-operatives), as it acts co-operatively only in New Zealand and as a corporate elsewhere.

¹² Tony Balwin, The Waikato Times, 7 May 2002.

4.4.3 Statistics and key figures

Fonterra is a co-operative owned by 13,000 New Zealand farmer-shareholders. Fonterra is a huge multinational company with 20,000 employees and over 90 subsidiary and associated companies spread over the five continents working either for NZMP (35% of the workforce) or for New Zealand Milk (63% of the workforce).

The key figures for the season 2001-2002 are the following: revenues of US\$6.8 billion (NZ\$13.9 billion), assets of US\$5.8 billion (NZ\$ 11.8 billion), and shareholders' equity of US\$2.5 billion (NZ\$4.5 billion).

Of the total figure of \$13.9 billion in revenues, \$7.7 billion (56%) were generated by NZMP, \$5.5 billion (40%) were generated by New Zealand Milk and \$575 million (4%) were generated by other units within the group (i.e. Fonterra Enterprises). The Americas is the biggest source of revenues for the company (32%), being followed by Asia (27%) and Australasia (21%) (Table 13 & Figure 3).

In terms of the company's performance related to its New Zealand farmer-shareholders, Fonterra processed a record amount of 1.1 billion kilograms of milksolids from its New Zealand farmer-shareholders, generating a record payout of \$5.33 per kgms, although this was achieved with \$50 million from reserves. The payout represents a 20-year record high for New Zealand dairy farmers (Figure 4).

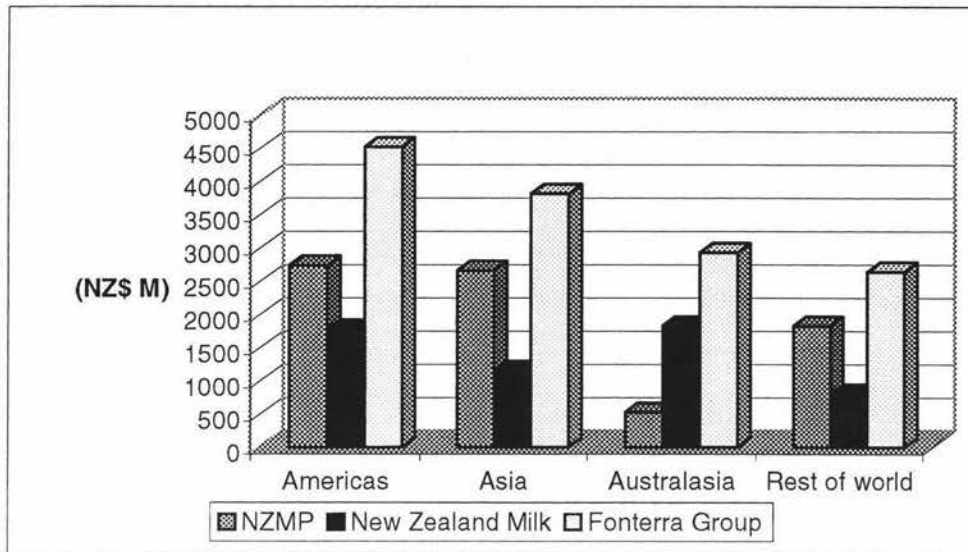
In terms of its financial situation, Fonterra has assets with a total value of \$11.8 billion and liabilities valued at \$7.3 billion, therefore its equity is \$4.5 billion. The company's equity/total assets ratio is 38%.

Table 13: Fonterra's revenues by business unit and region (season 2001-2002)

Revenues (NZ\$ million)					
	Americas	Asia	Australasia	Rest of world	Total
NZMP	2,741	2,664	530	1,831	7,766
(% of total)	19.6%	19.1%	3.8%	13.1%	55.8%
New Zealand Milk	1,781	1,154	1,833	815	5,583
(% of total)	12.7%	8.2%	13.1%	5.8%	40%
Others			575		575
			4.2%		4.2%
Fonterra Group	4,522	3,818	2,938	2,646	13,924
	32.5%	27.4%	21.1%	19%	

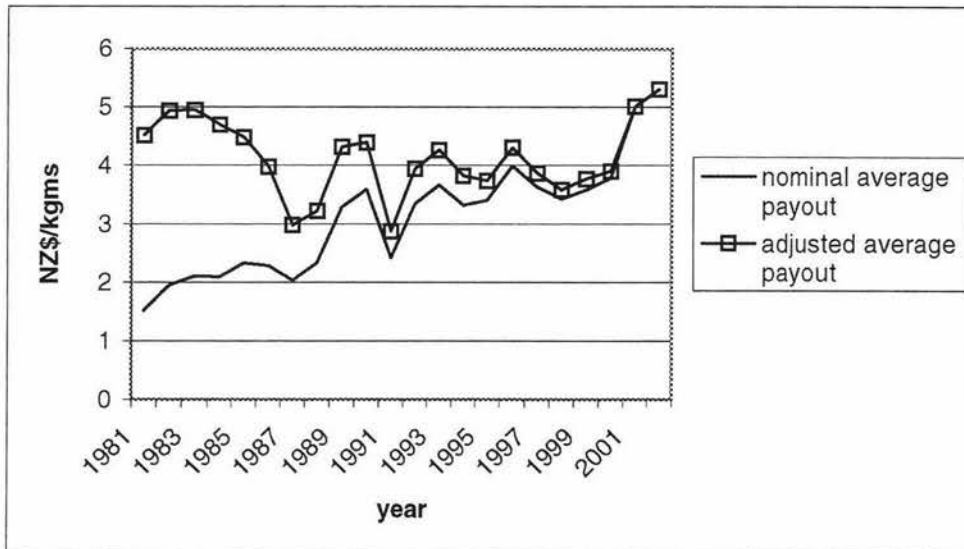
Source: Fonterra Annual Report (2002).

Figure 3: Fonterra's revenues by business unit and region (season 2001-2002).



Source: Fonterra Annual Report (2002).

Figure 4: New Zealand dairy farmers milk payout by season (1981 to 2002).



Source: Based in LIC (2002).

4.4.4 Organisational structure

Although Fonterra is a multinational company with over 90 subsidiaries, its organisational structure is fairly simple (Figure 5). The company is strategically lead from a Corporate Centre based in Auckland, where the CEO, the Managing Director of the business units (NZMP and New Zealand Milk) and other high level management staff, as well as the Chairman of the Board have their offices. Fonterra has three main operating divisions: NZMP, New Zealand Milk and Fonterra Enterprises.

NZMP (Fonterra’s ingredients business) is Fonterra’s largest business, responsible for generating revenues of \$7,766 million (56% of total Fonterra revenues) employing almost 7,000 permanent employees. NZMP can be defined as a fully integrated stand-alone company responsible for collecting the milk from the farms to the factories, processing it, manufacturing products and marketing them overseas, quoting the company’s definition of a ‘cow to customer value chain’.

The scope of NZMP operations encompass the collection of milk equivalent to 1.1 billion kgms from 13,000 supplier-shareholders in New Zealand, manufacturing over 1.7 million

tonnes of dairy products, that are marketed through a global network of subsidiary offices and sale agents or directly sold to multinational customers like Nestlé, Dumex, Kraft and NZMP's sister company, New Zealand Milk. NZMP is also responsible for the collection, processing, manufacturing and marketing of externally sourced milk. In the season 2001, a total of 151,000 tonnes of externally sourced (non-New Zealand) dairy products were sold, equivalent to just about a 10% of the volume sourced from its supplier-shareholders.

Although NZMP, as the ingredient business of Fonterra, is strongly based on selling commodities, new venture-products such as Whey Protein Isolate¹³ and organic dairy ingredients are also part of its product portfolio.

New Zealand Milk is Fonterra's consumer products and food service business, generating revenues of \$5,583 million (40% of total revenues), employing over 12,500 employees (around 60% of total workforce). New Zealand Milk has a global network of operating companies marketing consumer branded-products. Some of its major brands are: Anchor™, Anlene™, Fernleaf™, Chesdale™, Tararua™, Mainland™, Meadowfresh™, Tip Top™, Peters & Brownes™, Bega™ and Soprole™. New Zealand Milk is one of NZMP's larger customers.

Fonterra has four dairy product groups that span both NZMP and New Zealand Milk:

- Milk powders: whole milk powder, skim milk powder, nutritional products (e.g. infant formulae) and speciality products.
- Proteins: casein and whey¹⁴.
- Cream products: butter, anhydrous milk fat and other fractioned cream products, and bakery and food ingredients products.
- Cheeses: from commodity-type cheeses to branded products.

Fonterra Enterprises is the third leg of Fonterra Group, holding businesses that do not fit in either NZMP or New Zealand Milk, responsible for about 4% of Fonterra's total revenues.

¹³ To be manufactured in JV with DFA.

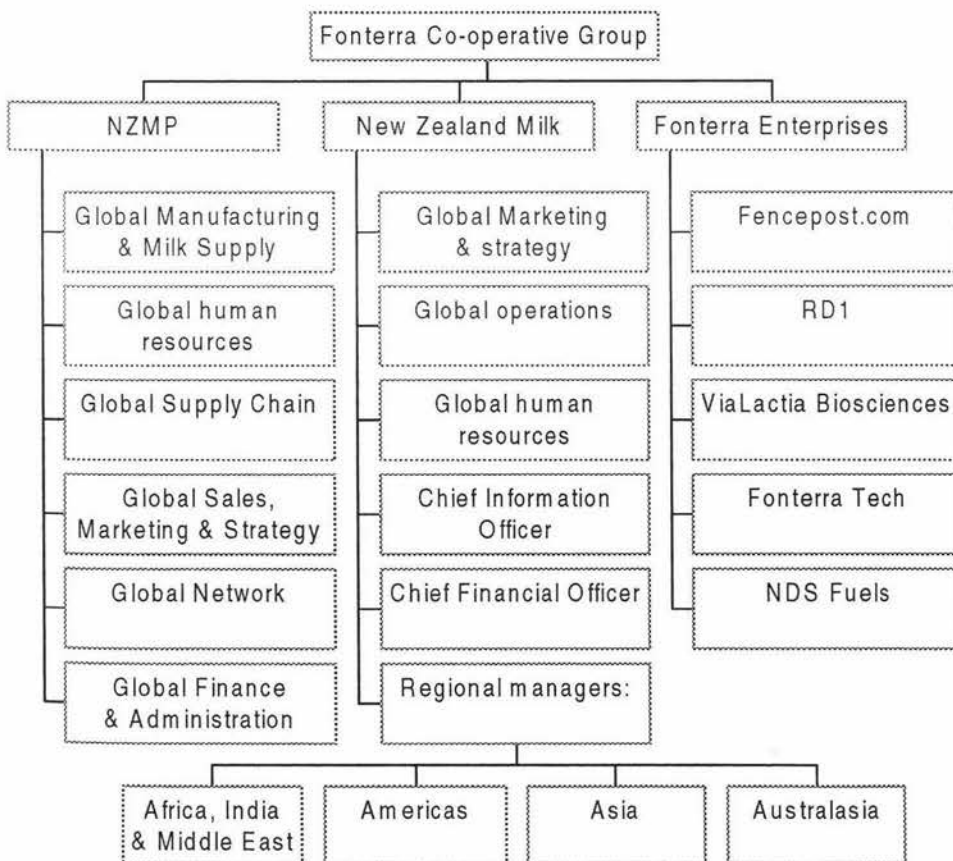
¹⁴ Whey is the term for the watery part of milk that remains after the elaboration of cheese.

Fonterra Enterprises is led by the Chief Development Officer and includes Vialactia Biosciences, a biotechnology business; RD1, a farm supplies retail business; Fencepost.com, an on-line farming services business; Fonterra Tech, a technology development business; and NDS Fuels.

RD1 is the biggest business within Fonterra Enterprises, generating annual revenues of over \$440 millions. RD1 is a rural retailing business which combines 51 stores, a nationwide network of technical sales representatives, on-line retailing and telephone retailing. RD1 was formed out of the merger of the legacy companies retail businesses RD1.com and Town & Country Agricentres.

Not included in any of the three main businesses but reporting directly to the corporate centre are two of Fonterra’s key units, the Shareholder Service division, reporting through the Chief Financial officer, and the Fonterra Research Centre, reporting through the Chief Development Officer.

Figure 5: Fonterra Co-operative Group organisational structure.



Source: Fonterra (2002b)

Note: In October 2002 Fonterra announced a major restructuring, moving NZMP from being an independent business unit to become the company's core business, reporting to the CEO through the newly created position of COO.

4.4.5 Capital structure and financing

Fonterra has a pure co-operative capital structure, where the totality of the company's equity is the property of its farmer-shareholders. Unlike other co-operatives, Fonterra has not had great constraints on the amount of available capital for investment and proof of that is the recently undertaken set of acquisitions, mergers and joint ventures.

Shareholders' equity is \$4.5 billion, situating the company in a reasonably strong position for future investment requirements. In 2002, further capital strengthening of the company was achieved through a \$200 million issue of capital notes (listed on New Zealand Stock Exchange) and a \$1.02 billion issue of Eurobonds.

As stated, Fonterra, and the NZDB previously, has been able to raise capital from its members and from its strategic partners, through JVs and alliances, in order to fund offshore investment. As further expansion is the target and investments become more distanced from the 'core business', questions arise again, in terms of how will Fonterra finance future offshore investments.

With the formation of Fonterra a totally new capital structure, innovative in world standards, was formed, with different equity and debt instruments, as well as new economic indicators. These can be understood in the following two equations:

Shareholders' investment in Fonterra comprises:

Shares+ peak notes = value of shareholders investment in Fonterra.

Shareholders' returns in Fonterra comprise:

Actual Milk Return (AMR) + Value Added component + Change in FVS price

4.4.5.1 Capital structure components

Fair Value Share (FVS)

The main component of Fonterra's capital structure is the Fair Value Share. Supplying shareholders¹⁵ own one share (FVS) for every kilogram of milksolids they produce. The FVS price is based on estimates of the company's future earning potential and changes over seasons ahead. To determine the FVS, essentially what is done is all the assets of the business (tangibles and intangibles) are added up, all the liabilities are taken off and then divided by total milk solids production.

The price of the FVS is determined by the company within a range independently set by the company's valuer (currently Standard & Poor's) on a yearly basis and is not changed until the next season. For the season 2001/2002 the FVS price was determined to be \$3.85 per share. Although milk payout still remains as the essential measure of the company's short-term performance, changes in the value of the FVS provide a measure of long-term value creation. At the same time the FVS overcomes one of the traditional limitations of co-operatives, the free rider problem, as it forces those recently joining Fonterra or increasing their production, to contribute capital according to the company's value and equally enable people leaving Fonterra to take the fair value of their ownership of the business with them.

Peak notes

Farmer-shareholders have to buy a certain amount of peak notes from Fonterra based on their milk supply profile during the season in relation with the company's curve. Unlike FVS, peak notes will always be redeemed at their original issue price (about \$1 per kg ms).

¹⁵ Sharemilkers can also own shares in Fonterra.

Traditionally New Zealand dairy production has been strongly seasonal with a marked 70-day peak. Peak notes fundamental driver is to deal with this oversupply, making extra 'peak milk' pay for the extra infrastructure required. Also, peak notes have the effect of flattening the production curve and by that way achieve greater utilisation of manufacturing infrastructure, theoretically lowering the cost of production per unit.

Capital notes

Capital notes are in essence a loan to the co-operative. They are issued to shareholders leaving the co-operative or decreasing supply. The holder of the note receives an income stream from the interest payments and may sell it on the secondary market. Anyone can purchase the notes, however no voting rights are attached to them. In October 2001 Fonterra issued NZ\$200 million in capital notes. The logic behind the capital notes is to enable shareholders who cease supply to access the value of their investment in the company (FVS and peak notes), whilst preserving the financial viability of the business for those remaining.

Supply redemption rights (SRR)

At the request of a shareholder decreasing supply, supply redemption rights may be issued for payment or part payment of FVS surrendered (not for peak notes). SRR can be paid by Fonterra with cash, capital notes, redeemable preference shares or a combination of them.

Redeemable Preference Shares (RPS)

RPS are a tradeable equity instrument that may be issued to farmers as payment for shares, peak notes or SRR only if the 5% threshold applies¹⁶. RPS must pay a dividend at least equal to 50% of the interest given by capital notes.

4.4.5.2 New economic indicators

Fonterra has implemented a set of new economic indicators, by separating the commodity milk returns or Actual Milk Returns (AMR) from added value returns. The indicators enable

¹⁶ The threshold rule is related to the possibility of a big quantity of shareholders retiring collectively from Fonterra, therefore putting the company and remaining shareholder in a financially risky situation.

the differentiated assessment of the performance of the commodity business and the return from value-added activities. Therefore farmer-shareholders are able to more clearly separate the returns they get from producing milk, from those they get from their shareholding in Fonterra. The mechanisms are explained by the following equation:

Milk Payout = AMR + value added component

AMR, the actual commodity price that Fonterra achieves less its actual cost of producing and selling those commodities, can be compared against the theoretical benchmark Commodity Milk Price (CMP). The CMP, calculated by Fonterra's valuer, Standard & Poor's, has been defined as a theoretical measure of what an efficient commodity producer would pay for milk and still make an adequate return on capital.

The second component of the milk payout is the value added component, which is the total payout less AMR. In other words, the cash return paid to shareholders from Fonterra's investing activities less retentions made by the company for investments, which although are not paid out to shareholders are reflected in the FVS price.

As explained by the Shareholders' Council report, Total Shareholder Return (TSR) after tax, can be defined as:

$TSR = (\text{Payout} - \text{CMP}) \times (1 - \text{tax rate}) + \text{Change in the FVS price}$

4.4.5.3 Capital structure review

Fonterra's capital structure and economic indicators have been widely recognised as very innovative by world standards and to effectively address some of the traditional limitations of agricultural co-operatives. On the other hand, some of its components have been questioned for their complexity and also some of the future implications of the international business strategy over the current capital structure¹⁷ are forcing Fonterra to review it: "A *full and*

¹⁷ See Van Der Poel's article in the Dairy Exporter magazine 2002.

considered review of Fonterra's capital structure should be undertaken. It was recommended that Council representatives be involved to ensure shareholders' views and concerns are taken into consideration during this review" (Fonterra Shareholders' Council Report, 2002, p.23).

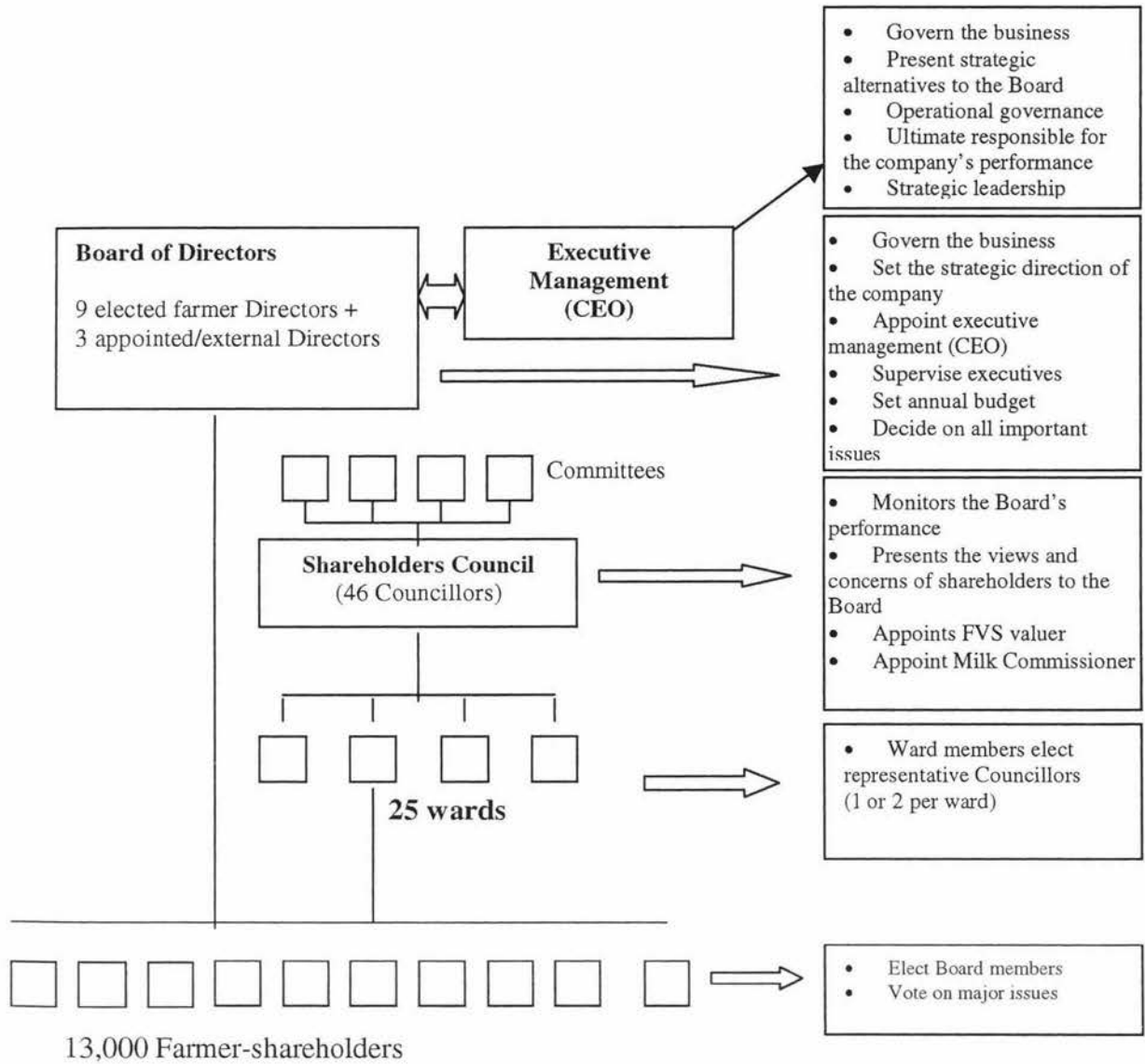
Peak notes and the complexity of its calculation system has been one of the most questioned mechanisms of the capital structure and as a consequence the company has promised a review of it. Besides complexity concerns, questions have also arisen related to the potential impact over farmers' production that moving away from the optimum grass-growth curve could have, versus the efficiency gains the company can make.

Extremely important to the capital structure review will be both the Co-operative core values report and Project Galileo (strategy review). Anyway, it is unlikely that drastic changes will arise out of the capital review and it is more likely to see an evolution of the current one.

4.4.6 Governance structure

Fonterra has a pure co-operative governance structure made up of three main bodies: (1) Executive management and (2) the Board of Directors (these two are considered the governors of the business) and (3) the Shareholders' Council as the representative body (See Figure 6). For all very important decisions and for the election of the Directors of the Board, members have a direct vote, for all other matters Directors of the Board decide on representation of farmers.

Figure 6: Fonterra's governance structure¹⁸.



Source: Fonterra Annual Report (2002), Shareholders Council Report (2002) and Rabobank (2001a).

¹⁸ By the end of 2002 the chairman of Fonterra at the time this Report was being done, John Roadley, will leave the Board and a new external Directors will be appointed, so a final mix of 9 elected Directors and 4 appointed will be set.

4.4.6.1 Executive Management

Executive Management are effectively in charge of implementing the chosen strategies and running the day-to-day business. In terms of strategy setting, the executive management takes strategic options to the Board, which in turns accepts or rejects them, to be again implemented by management.

As of September 2002 Fonterra's key senior executives were:

- Chief Executive Officer (CEO): Craig Norgate
- Chief Financial Officer (CFO): Graham Stuart
- Chief Development Officer (CDO) & Managing Director of Fonterra Enterprises: Alexander Toldte
- Group Director Human Resources: Glen Petersen
- Managing Director NZMP: Chris Moller²⁰
- Managing Director New Zealand Milk: David Pilkington

The Chief Executive Officer (CEO) is the leader of the executive management team. Craig Norgate's role, as CEO of Fonterra, is of strategic leadership just like in any IOF type company but there is also an additional set of imperatives around a co-operative type business like Fonterra in terms of its relationship with farmers and farmers' representatives (i.e. Director and Councillors).

4.4.6.2 Board of Directors

Fonterra's Board of Directors is composed of 13 Directors, 10 of whom are elected-farmers Directors and three of whom are appointed Directors. By the end of year 2002, when Chairman John Roadley retires, the composition will change to nine elected Directors and four appointed Directors (9+4), therefore maintaining the total number of Directors of the Board in 13.

²⁰ With the reorganisation of Fonterra announced in October 2002, Chris Moller announced his resignation from the company. The role of Managing Directors of NZMP was replaced by the newly created Chief Operating Officer (COO).

Directors of the Board are key players in Fonterra's structure. Among the key responsibilities of the Board of Directors are: the establishment of the strategic direction of the company, appointment of the CEO and monitoring of the company's performance. Other important responsibilities include ensuring a high level of interaction with shareholders.

Farmer-Directors are elected by farmer-shareholders, with a third of them having to retire each year with the possibility of seeking re-election. Voting is on milksolids production, with shareholders receiving one vote for every 1000 kg ms, with no cap on votes. Directors are elected on a national basis, so they do not represent regional shareholders' interests, although the original Board was established with five farmer-Directors of each of the two legacy companies.

In order to broaden the skill and knowledge base of the Board and to complement elected-Directors knowledge, there are three (soon to be four) appointed-Directors. Appointed Directors' skills are likely to be in running multinational companies, understanding global markets and in corporate governance, knowledge that might not necessary be among the farmer-Directors and the complexity of the business demand. According to the company, appointed Directors are likely to be individuals with experience in multinational companies at the CEO and CFO levels and/or having held Directorships of global companies, as well as having an extensive network of business contacts. Also important is that they will have to have empathy with the co-operative ownership structure.

Farmer-Directors have two main roles, to govern and to represent farmers. In order to fulfil its governing role, Directors have access to detailed numbers about all key investments and individual companies of the Group around the world. Directors also have to travel regularly to spend time at the international operations. In terms of fulfilling their representative role, Directors have to spend time at meetings with shareholders to communicate the company's strategy and make sure farmers understand it.

The Board is internally organised into three sub-committees: the audit, finance and risk committee; the appointments, remuneration and development committee; and the shareholder

management committee, which manages the relationship between shareholders and the company²¹.

As of September 2002, Fonterra's Board of Directors was the following:

- Henry Van der Heyden, Chairman of the Board
- John Roadley: (Chairman of the Board until September 2002) to resign at the end of 2002.
- Greg Gent: Deputy Chairman until September 2002.
- Richard Booth
- Mark Townshend
- Harry Bayliss
- Dr. John Hood (appointed Director)
- Graeme Hawkins (appointed Director)
- Marise James
- Murray Flett
- Earl Rattray
- Jim Van der Poel
- David Hoare (appointed Director)

4.4.6.3 Shareholders' Council

The Shareholders' Council is a body made of 46 shareholder representatives (Councillors), representing 25 wards. Each Councillor roughly represents 300 farmers and unlike Directors who are representatives of the totality of farmer-shareholders, Councillors represent only farmers from their wards. The Shareholders' Council operates with a budget of approx 0.3c/kg ms. The Shareholders' Council budget has to be approved every year by farmers-shareholders.

²¹ In October 2001, newly assumed chairman Henry Van der Heyden restructured the Board's sub-committees, increasing their number and abolishing the position of Deputy Chairman.

Just like Directors, Councillors are elected for a term of three years, with one third retiring by rotation each year; Councillors in turn elect the Chairman of the Council. Although Fonterra's Shareholders' Council is very unique, there are similar structures in other dairy co-operatives like Dairy Farmers of America in the US and Dairy Crest in the UK.

The Council's main responsibilities are to monitor performance of the business and to represent the views of the shareholders to the Board and by that way help the Board in its representing role. Other responsibilities of the Council include the appointment of the Milk Commissioner (to help resolve disputes between suppliers and Fonterra) and the appointment of the 'valuer', currently Standards' & Poors.

One of the Council's most important roles, if not the most important, is to represent the shareholders' views back to the Board of Directors. In order to do that, Councillors have established 'supplier networks' within their wards, some of them in more formal ways than others. One point that the Council has been repeatedly clarifying is that it is not the Council's role to undertake any of the Board's governing powers or its responsibility to communicate directly with shareholders or even to act as an intermediary between Board and farmer-shareholders.

In order to fulfil its performance monitoring role, the Council receives quarterly financial reports from the Executive Management and also, annually, the Board presents the Council a document called the Statement of Intention that sets the key performance targets for the coming season. The Council uses outside help and advice to efficiently evaluate the company's performance. The Council finally writes the Shareholders' Council Report to all shareholders, which in detail analyses the performance of the co-operative for the shareholders understanding, besides describing the Council activities over the year.

The Council, like the Board, is internally organised in committees. Committees currently in place are: (1) performance committee; (2) constitution/ by-laws/co-operative principles committee; (3) training committee; (4) supplier issues committee; and 5) special projects committee.

The Council meets once a month plus special meetings, although Councillors are in constant contact. The Council, with the support of 75% of the Councillors, has the power to call a Special General Meeting for all shareholders to resolve a specific issue, although it constitutes an extreme measure. The Council can also instruct or request special reports to the executive management, if considered necessary. The Council and the Board meet about 7-8 times a year.

4.4.6.4 Board and Council interaction

It is appropriate to highlight that the interface between the Council and the governors of the business (Directors and executive management) is still developing and as a consequence problems related to information's flows arose during the first year. The reasons can be found on several streams like transition into new roles, lack of Council traditions and others, but the fact is that Fonterra needs to work on improving internal relationships between its representative and governing bodies, and although it can be argued that a degree of tension is healthy, management, Directors and Councillors need to learn fast.

“Information provided to Council through the year was late, incomplete and subject to change. This continues to be a source of frustration to Council in undertaking its performance monitoring role on behalf of shareholders” (Fonterra Shareholders' Council Report, 2002, p.4).

4.4.7 Knowledge creation and Research & Development (R&D)

4.4.7.1 Knowledge Creation

Nonaka (1986, p.681) stated: *“when markets shift, technologies proliferate, competitors multiply and products become obsolete, successful companies are those that constantly create new knowledge, disseminate it widely through the organisation and quickly embody it in new technologies and products”*.

Knowledge is the underpinning factor that links all Fonterra's core capabilities: its sourcing, processing and product development capabilities and also its supplier-shareholders' low cost of production. Because of being a co-operative, supplier-shareholders and the company's capabilities are intimately related. Therefore innovation, the continuous creation of knowledge, is critical for the company: *"In an increasingly competitive world, innovation is the key to long term competitive advantage"* (Fonterra Annual Report 2002, p.320).

Knowledge creation in Fonterra occurs at different levels and areas of the company, such as R&D, processing and marketing. Also important to note is that the key catalyst of knowledge creation are people and therefore Fonterra needs to continuously attract, upskill and retain talented people from within the New Zealand dairy industry, but also from other industries and from other countries around the world.

In the areas of processing and product development, Fonterra has a Graduate Training Programme in place, which is a year-long intensive programme that leads to the award of Masters of Dairy Science and Technology, jointly awarded by Fonterra Research Centre and Massey University, with lectures, research projects and practical experience at the processing plants. Participants of the program can be either employees of Fonterra or customers of Fonterra who are sponsored by the company to attend the course.

Fonterra, through the Fonterra Research Centre, also offers, Skill Courses for advanced training in the manufacturing processes; Application Courses for dairy products applications; and Customised Courses for different sectors of Fonterra.

At senior executive level there are monthly Executive Management Team meetings, held by Fonterra Research Centre senior executives with the R&D managers of New Zealand Milk and NZMP as well as with the Corporate R&D Manager. Finally, on the top of the organisation there is the Innovation Forum, consisting of meetings of the senior business managers, the Global R&D Director and the Chief Executive of Fonterra Research Centre, being responsible for ensuring that research is in line with commercial objectives of NZMP, New Zealand Milk and Fonterra Enterprises.

In terms of organisational learning, Fonterra organises an annual Leadership Congress, which brings together the Group's top executives, about 120, from around the world to Auckland for two days of presentations, information sharing and interactive sessions. The same kind of meeting is also held within the business subsidiaries as well.

Again, an issue that Fonterra and its supplier-shareholders need to address is whether on-farm innovation is or is not a role of the company, because although Fonterra still supports research and innovation at farm level it has no direct responsibility on it and the question that needs to be answered is: does the company risk losing one of its core competitive advantages, the low cost of production of its raw material?

4.4.7.2 Research and Development (R&D)

Research & Development represents Fonterra's main vehicle for knowledge creation and definitively one of the company's core capabilities. Proof of that is the fact that in the 2000-2001 season, a very impressive figure of \$2.4 billion in sales revenues were originated from products launched in the last five years, representing 26.6% of total product sales.

Within the many research projects currently being carried out, key initiatives include: new consumer products, processing technologies, patent applications for processes, discovering of biologically active milk components, nutraceuticals and pharmaceuticals, etc.

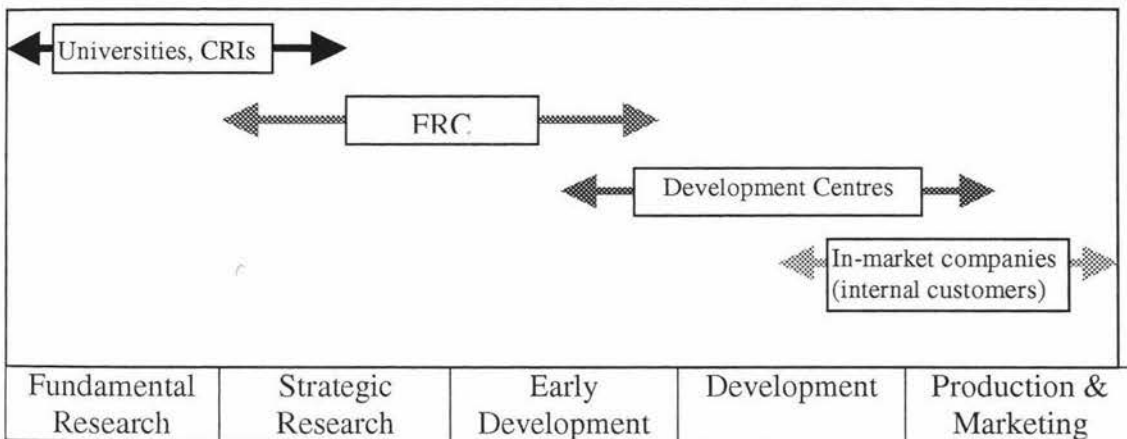
Fonterra has an annual R&D budget of more than NZ\$100 million, representing about 0.7% of its sales, with R&D being carried out by Technology Leaders in six areas: food and environmental assurance, food systems, bio-actives and health, process technology, on-farm productivity and intellectual property, all of them reporting to the Global R&D Director. The cornerstone of Fonterra's R&D network is the Fonterra Research Centre (FRC), with biotechnology research being separately carried out by ViaLactia Biosciences and with Fonterra Tech having a related role²².

²² Fonterra Tech, one of the companies of Fonterra Enterprises, is in charge of the commercialisation of technologies developed by the company or even brought in, which are outside of the main subsidiaries (NZMP and New Zealand Milk) areas.

Vialactia Biosciences: Fonterra’s wholly owned biotechnology company which develops and commercialises new biotechnology products, services and technologies for the dairy industry, through bovine, forage and rumen research programmes.

R&D is carried out through a network consisting of the Fonterra Research Centre (FRC) and ViaLactia Biosciences as major research providers, Regional Development Centres located around the world and Technical Centres of Excellence located at the manufacturing plants (Figure 7). Fonterra also has close R&D links with New Zealand’s Crown Research Institutes and with several Universities, both in New Zealand and overseas (Figure 8).

Figure 7: Fonterra’s R&D system.



Source: Fonterra Research Centre (2002).

It is interesting to note the similarity of Fonterra’s R&D system with Nestlé’s R&D system, which is based on ‘four pillars’: The Nestlé Research Centre, the Product Technology Centres, the Application Centres and the Application Groups. But while Fonterra spends in R&D an equivalent to 0.7% of its sales, Nestlé spends 1.33%; in other words almost double (Davidson, 2002).

4.4.7.2.1 Fonterra Research Centre (FRC)

Located in Palmerston North, New Zealand, the FRC is the primary unit within Fonterra’s R&D network, and in fact the primary knowledge hub for Fonterra Group. Established in

1927 (75 year of history), the former New Zealand Dairy Research Institute was renamed in June 2002 the Fonterra Research Centre (FRC). With a staff of about 350, the FRC is located in what can be called a 'Sciences community', with neighbours and project partners including CRIs (Crown Research Institutes): HortResearch, AgResearch, Crop & Food Research; and Massey University, among others.

The FRC has modern facilities, with the best equipped laboratories exclusively-dedicated to dairy anywhere in the world and a pilot plant, which allows the FRC to make most of the dairy products that can be manufactured by Fonterra and others that currently are not manufactured by the company. The site also has an extensive library and consumer panel facilities for market research purposes. The FRC is 92% funded by Fonterra, with the remaining 8% being contestable funds (currently Government funds).

Even though the FRC can be considered Fonterra's knowledge hub, it is mainly involved with product development, process development, technical support area and industry training: *"Even though FRC's main role is to be a provider of: consumer products, specialty ingredients, and process technologies, it is also a provider of knowledge management, intellectual property management, technology planning, consumer research, technical support, and training"* (Fonterra Research Centre 2002, p.19). Although the FRC does not have on-farm R&D programs, Fonterra has linkages with organisations such as Dexcel and Livestock Improvement from the farming area and is associated in programs related to the reduction of greenhouse emissions, wastewater treatment and others.

The FRC prides itself on being commercially aligned and the key point in terms of its link with the businesses is its matrix structure and client managers that work with the businesses to identify their needs. The FRC's matrix structure consists of resource managers (Science, technology and service) on one side and program managers (bioactives, environment, cheese ingredients, food service, etc) on the other side, who in turn get the funding from internal customers. In general terms FRC's priorities are set from the business units.

Beside the Fonterra Research Centre, other important units within Fonterra's R&D global network are the Development Centres, with five of them located in New Zealand and another five located overseas as follows:

- New Zealand-based Development Centres (5) are specialised in the areas of: Nutrition, Cream & Powders, Whole proteins, Cheese & separated proteins, and Packaging.
- International Development Centres (5) are located in: Rellingen (Germany), Bahrain (Middle East), Kuala Lumpur (Malaysia), Guadalajara (Mexico) and Santiago (Chile).

Finally the network is completed by the Technical Centres of Excellence, which are located at the manufacturing sites (Figure 8). At Fonterra's Centres of Excellence, marketing plans for each product category are developed and tested for use on a regional basis, as well as solutions for specific requirements that arise from different diets at country or regional level.

Fonterra also has a very wide network of external relationships and alliances in the R&D area. In New Zealand, there are over 28 organisations including Universities, Crown Research Institutes, Dexcel, Livestock Improvement Corporation²³, and others that Fonterra works with, and globally the number goes to over 100 (Figure 8). In terms of its links with New Zealand University research, Fonterra has links with Massey, Auckland and Otago Universities among others.

4.5 Fonterra's internationalisation

4.5.1 Business internationalisation

²³In September 2002 Fonterra announced it will invest \$60 million into a JV (Boviquest) with Livestock Improvement Corporation, to match up specific gene sequences with commercially useful traits such as high milk production, levels of protein or milk fat content.

Internationalisation, even in its simplest form (i.e. exporting), can easily be argued to be the only choice for most agricultural co-operatives in New Zealand because of the very small domestic market. If Fonterra was located in the US for example, it is probable that its growth focus would be the domestic market instead of the international markets, as it is the case for example with Dairy Farmers of America²⁴, but because Fonterra is based in New Zealand and because of historical dairy production levels, it had no choice but to undertake the internationalisation path in order to survive. With a yearly production of over 1 billion kgms in a country of just over 3.8 million habitants, there is clearly no other option but internationalisation and this has been the case since the beginnings of the dairy industry in New Zealand.

When the name Fonterra was chosen after the merger was approved, there was an obvious focus in choosing a name that was linguistically and culturally acceptable internationally, a name that would not limit the company to a defined geographical position or country, not even to New Zealand.

Fonterra is a truly multinational company (Figure 9), involved in five out of the six modes/stages of internationalisation from simple exporting to the formation of alliances, according to the co-operatives' internationalisation model used in this study (see Figure 2).

To understand Fonterra's internationalisation it is important to understand its predecessor, the NZDB, considering that in many aspects Fonterra can be described as both a new company and an old company. Ten years ago Dobson (1990) described the internationalisation process adopted by the NZDB as a three-steps process as follows: the NZDB would initially work through an agent, then the NZDB would form a joint venture with the agent in order to expand sales and finally it would acquire the JV's partner and establish a subsidiary. This process would permit the NZDB to control risk and increase revenues.

Internationalisation, beyond the initial stages of simple exporting and use of traders, has happened over a period of 30 years and started with the objective of market diversification

²⁴ Dairy Farmers of America is the world biggest dairy co-operative but it is only a small player in the international dairy market.

when the UK entered the European Union and the New Zealand dairy industry found itself with huge production and no secure market anymore, therefore it can be argued that internationalisation was a production-driven response. In order to respond to the challenges, the NZDB developed a number of JVs, especially in Asia (Japan, Korea, Philippines, Taiwan). Later on, when the NZDB started its strategy of adding value, it looked at initially trying to grow it generically, country by country, with each subsidiary creating its own brands in many of the cases²⁵.

Fonterra finds itself now in front of new challenges, entering JVs of bigger scale than the NZDB ever did and entering into new foreign market service modes like the strategic alliance signed in 2002 with Nestlé in the Americas.

4.5.1.1 Exchange rate influence

An important point to note before analysing the different modes used by Fonterra on its international markets is that because Fonterra exports 95% of its production and because of the internationalisation strategy followed, it is a net buyer of New Zealand dollars, therefore an important part of its performance in terms of turnover is based on the exchange rate of the NZ dollar against foreign currencies. The foreign currencies in which the group primarily transacts are US dollars, Australian dollars, and European Euros.

In order to minimize its exposure to foreign exchange risk as a result of transactions denominated in foreign currencies the company has cover mechanisms. Considering that the US is Fonterra's biggest market, the performance of the NZ dollar against the US dollar has a huge impact over the company's performance and as a consequence over the farmers-shareholders' milk payout.

“As a general rule for every cent above US\$0.45 the dollar averages through the season, the impact is around 7c on payout. We have 64% of our US dollar exposure covered at an

²⁵ Source: personal communications with Directors of the Board.

average of US\$0.45. Had we had no cover in place the negative effect would be between 10 to 14 cents” (John Roadley, Chairman of the Board, Farmlink Magazine, June 2002, p.1).

4.5.1.2 Foreign Market Service Modes (FMSM)

4.5.1.2.1 Exports

Although Fonterra is a truly multinational company with wholly-owned subsidiaries and joint venture companies spread over the world, exporting is still Fonterra’s foreign markets main service mode. The United States is Fonterra largest export market with Japan being the second. The company’s top eight export markets are on the Pacific Rim.

Table 14 shows Fonterra’s main export markets, although determining what percentage constitutes intra-company trade and how much is directly exported to worldwide customers is difficult to determine.

Besides exporting dairy products from New Zealand to the world, Fonterra also exports dairy ingredients externally sourced to other foreign markets (i.e. Fonterra will become the largest exporter of skim milk powder out of the US due to a recently signed exporting agreement), but this will be treated as a different foreign market service mode.

As declared by the company, its exporting potential is greatest in markets that are net importers of dairy products such as South East Asia (especially Japan and Korea), the Middle East, North America and Latin America, Northern and Southern Africa, and China.

In terms of the product mix, Fonterra’s main export product by volume and value is whole milk powder, followed by cheese and with casein in a third position by value and cheese by volume.

Table 14: Fonterra's top 10 export destinations (2002)

Country	(US\$) Free on Board
USA	503,987,944
Japan	336,358,435
Philippines	203,292,966
Mexico	201,164,541
Malaya	186,992,803
Indonesia	179,837,539
Australia	162,982,064
Vietnam	154,362,914
Taiwan	138,256,075
United Kingdom	129,821,184

Source: NZ Department of Statistics cited by Fonterra (2002b).

4.5.1.2.2 Foreign Direct Investment

Fonterra operates in 140 countries either through New Zealand Milk or NZMP or through both, having 35 manufacturing plants spread in different parts of the world (plus 29 in New Zealand).

The extensive use of offshore marketing companies allows Fonterra to be closer to consumers securing more power and profit. The ownership of offshore manufacturing facilities also enables the company to sell more dairy products under its range of brands and the internationalisation of its capabilities on large-scale milk procurement as well as to overcome trade barriers.

In addition to the already existing world-reaching network of companies that Fonterra inherited from the NZDB, the company has continued an aggressive programme of acquisitions and Joint Ventures (JV) with other dairy and food businesses. Major acquisitions and JVs have been completed in Europe, the Americas, Asia and Australia over the first twelve months of the company's existence.

Some of the most important deals include a JV with Arla Foods in the UK, to merge the Anchor and Lurpak butter brands; a JV with Dairy Farmers of America (DFA) to become the first commercial manufacturer of milk protein concentrates in the US; two major acquisitions in Mexico, to secure leading positions in the cheese and spread markets; a JV with Britannia

Industries Ltd. to enter the Indian dairy market; and a JV formed with Ostankino in the Commonwealth of Independent States to manufacture and distribute dairy blends.

United States

Fonterra established the first commercial production of milk protein concentrate (MPC) in the US together with Dairy Farmers of America through a 50:50 Joint Venture called DairyConcepts. For that purpose a \$73 million MPC manufacturing plant is being built at Portales, New Mexico.

United Kingdom

In December 2001 Fonterra and Arla Foods, Europe's largest co-operative group, announced a JV to operate in the UK and Europe. The JV, 75% owned by Arla and 25% by Fonterra, brought Fonterra's Anchor brand and Arla's Lurpak brand together, number two and one respectively in the UK yellow fats market. The deal involved the merger of the existing operations establishing a new business responsible for marketing and distributing the brands in the British Isles and developing new products for the yellow fats and spreads markets.

Mexico

Through the acquisitions, in December 2001, of La Mesa and Eugenia businesses, Fonterra established itself as the leader in Mexico's cheese market, and number three in spreads. The acquisition is expected to increase New Zealand dairy sales in Mexico by more than \$200 million annually.

India

Fonterra announced in March 2002 that it has established a JV to operate in India's NZ\$50 billion dairy market. The JV Britannia New Zealand Foods Ltd., based in Bangalore, was signed between New Zealand Milk (with an investment of \$25 million) and Britannia Industries Ltd., a bakery business with a national distribution network, which has been moving into the dairy category. The JV will market processed cheese, butter, dairy whiteners, ghee and liquid milks.

Fonterra's interests in Australia

Of extreme importance in this analysis are Fonterra's interests in Australia both because of the strategic importance of Australia in terms of world dairy trade and because of the company's public definition of its home market considering New Zealand and Australia.

"A key characteristic of successful consumer goods companies, our aspiration, is that they have a strong home market. New Zealand small size means that, it alone does not provide the market base we need. For that reason we define our home market as including Australia" (Craig Norgate, CEO Fonterra Group, company statement, fencepost.com, May 2002).

Australia's strategic importance for Fonterra lies in the fact that Australia produces around 25% of the world's traded dairy products. That percentage added to the 36% of world traded dairy products produced by New Zealand (of which Fonterra controls 95%) imply that the potential for Fonterra in Australia are significant as Australasian production is reported to have the single biggest impact on world market prices

Also, the fact of having a home market of 23.6 million people instead of only 3.8 million²⁶, creates the economies of scale in plants, processing and distribution, as well as brand efficiencies across the Tasman Sea, which are easily rationalised due to the similarities of both markets.

In July 2002, Fonterra and Melbourne based Bonlac Foods announced the merger of their consumer food products operations in Australia and New Zealand bringing together the Mainland and Tip Top businesses in NZ, with the Bonland Dairies²⁷ and Peters & Brownes businesses in Australia under the name of Australasian Food Holding Limited (AFHL). The new company's portfolio covers milk, ice cream, cheese, butter, yoghurt, processed meats, and convenience foods. The creation of AFHL has been recognised as the first major initiative entirely generated by Fonterra under its new structure since the company was created.

AFHL is the single largest operating company within Fonterra Group and the largest company in the Australasian consumer dairy business, having estimated annual sales of more than \$2.3

²⁶ Australia's population is approximately 19.8 million people, which added to New Zealand's 3.8 million gives a total of 23.6 million.

²⁷ Until the merger Bonland Dairies was a consumer business 50:50 owned by Fonterra and Bonlac Foods.

billion. AFHL is 75% owned by Fonterra, and 11.5% owned by Bonlac Foods, with the remaining 13.5% being owned by the former owners of the Mainland and Peter & Brownes businesses. The company (AFHL) is considered by Fonterra as “*a strong platform for future growth in Australia*” (Fonterra Annual Report 2002, p.18).

Fonterra’s interests in Australia are manifest in the fact that one of Fonterra’s farmer-Directors, Harry Bayliss, is also a Director of Bonlac Foods, which is 25% owned by Fonterra and 75% owned by the Australian co-operative Bonlac Supply Co. Also David Hoare, an Australian businessman, is Fonterra’s new appointed Director, and the only one in the Board based overseas. Fonterra’s other interests in Australia besides AFHL and Bonlac Foods include an 18% stake in Australia’s only listed dairy food company, National Foods.

4.5.1.2.3 External sourcing

Although external sourcing (sourcing of products from other suppliers than the supplier-shareholders) does not constitute a foreign market service mode by itself and can be involved either in DFI and JVs, licensing, alliances and the establishment of transnational co-operatives, it is analysed independently because of the implications it has for agricultural co-operatives.

“If Fonterra wants to sell (offshore) yoghurt and semi-fresh high value products it needs to use non-New Zealand origin product. You can’t export water profitably so it makes sense for us to source these ingredients from other suppliers” (Greg Gent, Deputy Chairman, Farmlink magazine, December 2001, p.5).

In year 2001, a total of 151,000 tonnes of externally sourced (non-New Zealand) dairy products were collected, processed and marketed, equivalent to just about a 10% of the volume sourced from its supplier-shareholders.

Fonterra has 35 manufacturing plants outside of New Zealand, which receive and process milk externally sourced as well as dairy ingredients supplied from New Zealand in order to manufacture a diverse range of dairy products.

In August 2001, NZMP signed an export agreement with Dairy America²⁸, a marketing company representing major US dairy co-operatives including DFA, Land O'Lakes and five smaller co-operatives, to export skim milk powder from the US on commission and by that way become the largest exporter of that category out of the US.

4.5.1.2.4 Knowledge agreements

Although Fonterra does not use knowledge agreements as a FMSM on a strong basis, there are examples in Fonterra of internationalisation of products through licensing. As has already been seen, product development is one of the company's core capabilities; therefore it makes sense for Fonterra to license products developed by the company in foreign markets where trade restrictions, or knowledge or capital limitations apply.

DR10™, a probiotic bacteria (i.e. bacteria with beneficial health effects) identified and developed by the Fonterra Research Centre, is a good example of the previous point. Originally DR10 was commercially launched by New Zealand Milk under the name of Fernleaf Defense™, the product was then licensed to Danisco, one of the world's largest food ingredient companies, to sell the product in selected overseas markets.

4.5.1.2.5 Strategic Alliances

Nestlé/Fonterra Alliance in the Americas

In March 2002 Fonterra Co-operative Group and Nestlé S.A. signed a 50:50 alliance named 'Dairy Partners Americas' (DPA) which will set up JVs in North, Central and South America

²⁸ Dairy America controls 70% of the US sales of skim milk powder.

to market chilled dairy products, liquid milk and ingredient milk powders. JV companies formed under the alliance umbrella will have access to the brands of both companies. The alliance was classified by Fonterra's CEO, Craig Norgate, as "*New Zealand's biggest ever offshore commercial deal*" (Dairy Exporter magazine, May 2002, p.96).

DPA will initially have a staff of 10,000 and an estimated first year turnover of US\$1.4 billions in a dairy market worth US\$100 billion, and is expected to become the lead chilled and liquid milk products marketer in the region as well as the leading milk powder supplier. Prior to the agreement Nestlé was already Fonterra's largest client and largest competitor and now it has become its largest partner.

Although it can be argued that DPA is a JV of bigger scale than any JV done before by Fonterra, but still uses the same formula that the company and the NZDB have traditionally used, the implications in terms of the area served, the portfolio of businesses and products it will cover and also in terms of the combination of capabilities, classify DPA as a totally different foreign market service form: a strategic alliance.

It has been announced that DPA will amalgamate part of the businesses that Nestlé has in the Americas with some of the businesses Fonterra has in the Americas. Fresh milk for DPA will be sourced from the Americas itself but it will also represent opportunities for New Zealand sourced product including a \$300 million (60,000 tonnes) market for Fonterra's dairy ingredients (of New Zealand origin) as a result of being the alliance's preferred supplier.

The logic behind DPA is the combination of both partners' complementary capabilities, in other words the combination of Nestlé's capabilities in branding and marketing (including brand management, market infrastructure, market knowledge and contacts with local governments and organisations, etc) with Fonterra's manufacturing capabilities (including large scale collection, processing, manufacturing and product development). According to Rabobank (2002) the main aim is to improve the product – market combination in which both companies are relatively weak.

Questions arise in terms of how Fonterra and Nestlé will integrate its existing operations into DPA in every country in which the alliance intends to set JVs²⁹. Also, important questions from Fonterra's point of view arise in terms of how to protect its capabilities of being leveraged by Nestlé outside of the alliance area, the Americas, while at the same time not being too 'jealous' with knowledge in order to the alliance succeed. This particular issue will be discussed later when the implications of the internationalisation strategy adopted analysed.

4.5.1.2.6 The possibility of becoming a transnational co-operative

Even though Fonterra's leaders have made a clear point in stating that the possibility of becoming a Transnational Co-operative (i.e. having suppliers-shareholders overseas) is not in the immediate plans of the company and the debate has not even been held, Fonterra's current involvement with other co-operatives overseas and offshore experience supports the theory that the possibility is not outside the realms of logic.

At the moment Fonterra is a multinational company, which only operates as a co-operative in New Zealand, although it is a partner in business with several dairy co-operatives around the world such as Arla Foods in Europe, DFA in the US and Bonlac Foods in Australia.

Efficiency gains can be found in the transnational co-operative form as it has been experienced by several agricultural co-operatives recently, especially in Europe (Table 15). On the other hand the decision must obey sound commercial reasons and not ideological motivations, where there has to be a benefit primarily for New Zealand farmer-shareholders, as the co-operative must not forget that its main objective is to serve and maximise returns to its farmer-shareholders.

²⁹ Fonterra and Nestlé have not been able to integrate their Chilean operations due to monopolistic concerns from local producers and because of negative position to approve the merger of its Chilean partner in Soprole (closely related to the Catholic Church). The Catholic Church controls 44% of Soprole and Fonterra controls 51%. As a result Chile is the only country in America where the DPA alliance is on stand-by (La Tercera, newspaper, 9 June 2002).

Table 15: European transnational dairy co-operatives (1998)

	Activity	Turnover	Members: number & composition
Milchunion Hocheifel	Dairy	573 mill DM	3,050 members: 79% Germany, 13% Belgium, 8% Luxemburg
Arla Foods	Dairy	36,000 mill DKK	17,600 members: 54% Denmark, 46% Sweden

Source: adapted from Federation of Danish Co-operatives (2000).

Of interest are Fonterra’s CEO thoughts on the issue: *“Consider what has happened elsewhere around the world ...the case of Arla Foods, between Denmark and Sweden for example. What’s happened with the creation of Dairy Farmers of America in the US, where different states are like different countries elsewhere in the world; and they have been able to bridge those gaps. And the issues are no different to what they were here between the North and South island five years ago, and indeed between coastal Taranaki and South Taranaki 15 years ago. So much as you might find a lot of people averse towards it today, the reality is that the same forces have driven that sort of activity elsewhere in the industry over time and around the world; so I would never say never”* (Craig Norgate, CEO, Fonterra Co-operative Group, personal interview, August 2002).

Of extreme interest also, is Fonterra’s relationship with the Australian co-operative Bonlac when analysing the theoretical possibility of becoming an Australasian co-operative. Fonterra currently owns 25% of Bonlac Foods of which Bonlac Supply Co. owns 75%; in turn Bonlac Foods’ consumer business division, Bonland Dairies, was recently merged into AFHL. Fonterra’s involvement in Bonlac goes back to the NZDB days when the company saw synergies for what it was doing in Australia at a time when the Australian co-operative was in financial stress.

The partnership has apparently other benefits besides commercial synergies: *“Fonterra holds similar values to our own as a dairy co-operative and has become a true partner, not merely an investor. We have only seen the start of the benefits Bonlac and Fonterra can deliver to*

our respective shareholders by working together” (Noel Campbell, Bonlac Chairman, Dairy Exporter Magazine, January 2002, p.68).

Worthy of note in this aspect is the considerable number of New Zealanders currently dairying in Australia. At the beginning of 2002, Bonlac Foods organised nine meetings across New Zealand as part of a New Zealand dairy farmer/worker campaign using for that purpose former New Zealand dairy farmers currently succeeding in Australia.

If Fonterra eventually decides to accept overseas suppliers as shareholders there are key areas that need special attention like a transparent payout price in order to avoid cross-subsidisation, as well as issues around the capital structure that are not the purpose of this study to analyse. Also, and maybe of greater importance, before overcoming structural barriers the company will have to overcome cultural barriers³⁰.

At the moment Fonterra is focused on being a successful national co-operative first. It has gone through enormous changes over the last twelve months and its performance has been far from perfect as the Shareholders' Council Report highlighted. Will Fonterra eventually become a transnational co-operative? Time will tell, but of extreme importance to this will be Project Galileo and the 'Co-operative values and core principles' being prepared by the Shareholders' Council.

4.5.2 Knowledge and capabilities internationalisation

4.5.2.1 Core capabilities

³⁰ After the announcement of the formation of AFHL, Victoria dairy farmers president, Peter Owen, said, “*we would like the profits and money that circulate in the Australian dairy industry to stay here for the benefit of supplier*”. Simultaneously, on the other side of the Tasman, NZ Dairy farmers chairman, Kevin Wooding, said, “*farmers here want to know they won't be propping up their Victorian counterparts*” (fencepost.com, 2 July 2002).

“At the core of Fonterra’s success are two things: our shareholders’ ability to produce high quality milk in the most efficient manner, and the Group’s performance in manufacturing products of the highest quality at lowest cost and marketing them to customers who value the benefits they bring” (Fonterra Annual Report 2002, p.20).

Fonterra’s core capabilities can be arranged as on-farm capabilities and off-farm capabilities. In terms of the on-farm capabilities, New Zealand on farm productivity is the highest in the world (or the lowest cost of production); New Zealand farmers are reported to produce milk solids for around half the cost achieved by dairy farmers in the United States.

When considering these two core capabilities individually it can be argued that in fact New Zealand farmers on farm productivity and the company’s competence in large-scale milk procurement, processing, management and logistics are both based in knowledge. New Zealand farmers are the most efficient in the world because of their knowledge level.

A very topical discussion is to determine whether on-farm capabilities belong to Fonterra or not and therefore if it is able to freely internationalise them; at the moment these on-farm capabilities are not being used anywhere but in New Zealand.

If it is considered that Fonterra owns only off-farm capabilities (milk collection, processing, manufacturing and marketing) being the only ones that the company can freely leverage and internationalise, questions arise in terms of the company’s capacity of succeeding offshore by only leveraging half of its core capabilities and arguably its main source of competitive advantage. On the other side if Fonterra leverages and internationalises its on-farm capabilities, questions arise in terms of the implications this would have over its supplier-shareholders, that is New Zealand dairy farmers.

4.5.2.2 Capabilities internationalisation

4.5.2.2.1 On-farm capabilities internationalisation

At this point in time Fonterra does not have a defined official position about the internationalisation of its on-farm capabilities and, for example, the upskilling of Fonterra's suppliers in Australia, Brazil or India to produce milk more efficiently.

Although on-farm capabilities are often considered the cornerstone of Fonterra's advantage, the company finds itself somehow restricted for freely leveraging them, and needs to proceed carefully on this matter due to its co-operative nature. It can be said that this knowledge is institutional knowledge as opposed to intellectual property knowledge.

A factor to keep in mind is that New Zealand dairy infrastructure and New Zealand dairy farmers are a fundamental plank in the interpretation of Fonterra's on-farm technologies, therefore most of these technologies are not readily transferable. Another factor to keep in mind is that the mentioned on-farm technologies and knowledge are not the exclusive property of Fonterra and all New Zealand dairy farmers have access and proprietorship of that knowledge and most of those technologies are already finding their way to other countries through, for example, independent consultants operating in Australia, Brazil, Chile, etc. Following the same logic, as the knowledge is not exclusive to Fonterra, it is logical that the company finds a vehicle or mechanism to capture that value in benefit of all its shareholders instead of losing it.

The risks associated with the internationalisation of dairying technologies are related to a potential disadvantaging of the company's New Zealand farmer-shareholders in terms of their position in the global cost curve. As Fonterra is a co-operative owned by New Zealand dairy farmers it could find itself in the situation of leveraging on-farm technologies for the benefit of the company as a whole, while at the same time disadvantaging the owners of the business.

4.5.2.2.2 Off-farm capabilities internationalisation

The internationalisation of its collecting, processing and manufacturing capabilities is essentially what the company has been doing over the past years with its offshore partners, such as Bonlac in Australia.

According Fonterra's leaders there is still space for improvement on its offshore operations in, for example, milk collection and milk chilling, especially in the developing countries where the company is sourcing milk, before having to decide to internationalise or not its on-farm capabilities. So by simply internationalising those technologies the company can improve efficiencies.

In terms of more advanced off-farm technologies, such as information tools which are relevant to countries from the developed world like members of the EU, US and Australia, the company has manifested intentions of internationalising technologies such as fencepost.com. There is no downside in this respect and again the benefits are related to improving efficiencies of offshore core businesses as well as generating profit from added-value businesses.

In fact, the whole Shareholder Services system could, if proved successful in New Zealand, be internationalised as a competitive advantage in terms of the company's systems for managing relationships with suppliers and/or shareholders. The issue although, is only theoretical, as at this stage the Shareholder Services department face more immediate challenges in New Zealand.

The decision is even easier when talking about the internationalisation of products developed by Fonterra where proprietary rights apply. The company has proven capabilities in product development greatly thanks to the Fonterra Research Centre, as in the already seen case of the development of DR10™ and licensing of Fernleaf Defense™.

4.5.2.3 Knowledge internationalisation

Knowledge internationalisation, although less visible than business internationalisation and less conflictive than capabilities internationalisation, is a critical issue: *“A global business needs people who can lead across cultures. It may not sound the most exciting externally.*

However it is the most critical internally” (Craig Norgate, Fonterra CEO, Dexcel Ruakura Dairy Farmers Conference, Hamilton, 15 May 2002).

The company has historically been committed to expanding the New Zealand skill base with offshore people and the international nature of its 20,000 staff is a proof of that, especially at the marketing and R&D level. In addition, Fonterra’s global R&D network, consisting of over 100 international organisations that Fonterra has relationships and alliances with, gives the company a worldwide learning capacity (Figure 8).

“We recruit globally for positions, so you’ll see many nationalities represented in our staff. Obviously Kiwis, but also English or British people, Dutch, Germans, various South Americans, US citizens, Mexicans, Pacific Islanders and so on. If you are going to recruit the best, you have to recruit internationally” (Jeremy Hill, General Manager Resources, Fonterra Research Centre, personal interview, August 2002).

At the governing level, Fonterra is trying to incrementally internationalise its Board of Directors. The company has publicly manifested its intention of, in the future, having appointed Directors based in key trading markets, such as the Americas, Asia and Australia. The appointment of the Australian David Hoare, based in Sydney is a clear example of that policy.

4.6 Integrative structures

4.6.1 Governors/farmers interface

Interaction of members with governors, Directors and executive management, tends to be reduced if not minimal in large co-operatives. In Fonterra’s case, the Shareholders’ Council

intention is precisely to overcome that limitation, although Directors and CEO (in a limited way) are still expected to interact with farmer-shareholders.

In the case of the CEO, although its main role is to govern the business being the ultimate responsible of the company's performance just like in any IOF type company, there are additional tasks that demand of him, among other things, to spend about three weeks a year interacting with farmer-shareholders at different kinds of meetings.

In terms of the Directors' interaction with farmer-shareholders, this increases dramatically, at least in the case of farmer-elected Directors³¹. According to Fonterra's constitution Board members must always communicate directly with farmer-shareholders about the strategic direction of the company and be totally accountable for its performance in front of them.

The discussion about whether Directors should focus entirely in driving an increasingly complicated multinational business instead of spending time fulfilling its representative role and meeting with members is not new and has some supporters. Fonterra's Board of Directors has committed itself to concentrate on its governing role, but still be accountable for personally communicating with farmers about the strategic direction of the company and its general performance. The task is not easy, considering that there are eight elected-Directors to cover 13,000 farmers.

"One of the fundamental bottom lines is that farmers need to have confidence in my person as a Director. If they loose confidence in my integrity or my ability, -I'm just one Director obviously- but if they loose that confidence the whole industry [company] is in serious trouble" (Harry Bayliss, Director of the Board, personal interview, July 2002).

Directors fulfill their representing/communication role in several ways and through different mechanism, but in general terms two Directors attend meetings with farmer-shareholders and listen to feedback on topical issues. These meetings represent probably the only opportunities that farmers have to evaluate or 'get a feeling' of individual Directors for voting purposes.

³¹ Appointed-Directors are not expected to spend time communicating with shareholders regularly but focus on governing the business, setting the strategic direction of the company.

The previous point has important implications for the whole business, as good speakers are not necessarily good Directors or the other way around. Also, at the Annual General Meeting (AGM) and special general meetings Directors are usually spread among venues so farmer-shareholders have at least one of the governors of the business present, although AGMs are video linked.

The Shareholders' Council works as a link between shareholders and Directors, helping these last ones to fulfil their representing role. The Shareholders' Council is a representation of 46 Councillors for 13,000 shareholders, therefore an average representation of one representative for approximately every 280 shareholders. Councillors, unlike Directors of the Board who represent the interests of the totality of shareholders, only represents that specific group of farmer-shareholders within their ward, fulfilling an upward communication role for farmer-shareholders presenting their views and concerns to Councillors who in turn present them in an organised way to the Board of Directors.

For fulfilling their role each one of the Councillors has established 'supplier networks' in their own area; some of these networks operate in formal ways consisting of regular meetings with good attendance levels, while other networks operate simply by email or phone and the manifestations of interest from farmers have been scarce. The difference may be due, among other things, to different histories and traditions among regions³²; whatever the reason, this is an area that needs to be improved.

Besides supplier networks, Councillors organise sporadic supplier meetings, where Directors of the Board, members of the executive or even outside experts, depending on the subject, make presentations and discuss specific areas with farmers.

As Councillors have been finding over recent months, the Councillor's tasks demands a large amount of time (probably larger than some originally thought), as besides meeting once per month with the other Councillors and organising supplier meetings and supplier networks, Councillors should be constantly assisting to public meetings and be contactable by farmers

³² Among the parent co-operatives that formed Fonterra, the New Zealand Dairy Group had a network mechanism in place while the Kiwi Group did not.

as well as be constantly up skilling themselves in order to understand the business to be able to fulfil their other roles such as performance monitoring. It must be understood that as Councillors undertake their role as a part-time job, they also remain responsible of running their farms and other businesses.

It is probably fair to state at this point that Fonterra as a whole, including Directors, Councillors and farmer-shareholders are still in a learning process in relation to the Shareholders' Council, its role, responsibilities and functioning as even the former New Zealand Dairy Group Council was a different body with different attributes and responsibilities.

4.6.2 Company /farmers interface

The interface between the company and its farmer-shareholders is fundamental in any co-operative and this is definitively the case in Fonterra. Most modern co-operatives have established in this critical area a normal customer-company relationship. By providing a premium-quality service and by developing ownership feeling, modern co-operatives can keep shareholders on-side when internationalising. Also, now that the New Zealand dairy industry is deregulated and potential competitors can attract suppliers from Fonterra, the necessity of providing a quality service and making supplier-shareholders feel themselves to be members of the organisation rather than simple suppliers, is more critical than ever.

“There has to be a loyalty factor that makes people proud to be members, otherwise we would lose them, because it will be just an economic response; we have to create some sort of membership value, some sort of ‘Fonterraness’ to keep people proud to be members, is something that we have to build, and we haven’t been that good at that on the last six months” (John Roadley, Chairman of the Board, personal interview, August 2002).

The Shareholder Services department is the primary interface of the company with its supplier-shareholder base. With an annual budget of \$45 million, Shareholder Services is an integral part of Fonterra.

Shareholder Services, based in Auckland, includes the following four divisions: Field teams, Contact Centre, Shareholder Relations and Financial Services (including fencepost.com) (Figure 10). Also, through a dotted line the General Manager of Shareholder Services is hierarchically the superior of the Shareholders' Council Manager, although this last one reports to the Chairman of the of the Shareholders' Council. The Shareholder Services has already passed by a big restructuring process since its creation less than one year ago³³.

Financial Services is the biggest area of Shareholder Services, being in charge of anything to do with paying farmers, capital structure and general administration. It constitutes probably the biggest payment system in New Zealand, paying about \$6 to \$7 billion annually to farmers, through monthly payments to about 13,000 different shareholders plus 5,000 sharemilkers. Fencepost.com is also under Financial Services, although it does not only provide financial information but also general communication through the Internet.

The Contact Centre is the next big part of Shareholder Services. With a staff of 25 and operating seven days a week, twelve hours a day, the basic aim of the Contact Centre is to be the main point for supplier-shareholders for all questions about the company. Operators are theoretically able to answer the majority of the questions or forward them to the appropriate person within the company. Also, the Contact Centre works as a Central hub for all operational issues such as collection and transporting issues.

The Field Teams division is made up of three field teams: the Field Representatives team, made of 35 people located across the country; the Milk Quality specialists team, made of six milk specialists; and finally the Environment team, which is actually a one-person team based in Auckland. Field Representatives are a key part of the Shareholder Services structure. There

³³ Besides the major restructuring that Shareholder Services suffered in mid 2002, its General Manger was replaced in late 2002.

are 30-35 Field Reps, one for about every 400 shareholders, although some areas are currently serving bigger numbers, and they are the farmer's personal contact with the company. Field Reps are generalist officers that know about milk quality issues, farm management, capital structure and all sorts of day-to-day operational issues. The six Milk Quality specialists are located in the major producing regions to provide a level of expertise on milk quality (technical information and assistance for farmers) that Field Reps, as generalists, do not have. Finally, the Environment person, although not properly in the field, works elaborating the protocols for the company on environmental issues.

The fourth division of Shareholder Services is Shareholders Relations, which is a recently created area that works across the different sections to manage communications with shareholders and other stakeholders such as the Shareholders' Council. This area is responsible for all communications that go to shareholders, including letters and Farmlink, a monthly magazine/newsletter. The communications budget of the Shareholder Services is \$4-\$5 million.

Shareholders Relations is also in charge of the evaluation of service, a key area for the company for finding service gaps and areas to be improved; although the whole system is in its infancy. Evaluation mechanisms contemplate weekly small-scale phone surveys and large bi-annual mail surveys (1,000 farmers). Also, at the end of 2002, 40 focus groups are planned to be held around New Zealand.

4.7 Integrative mechanisms

4.7.1 Communication

An effective communication is a key aspect for a co-operative the size of Fonterra; it is extremely important for the success of the company to align everyone in the business behind its strategy including: the Board of Directors, Executives Managers, its 20,000 staff

throughout the world and its 13,000 farmer-shareholders. For the purpose of this study we will mainly concentrate in communications with this last group.

As already stated, performance is the most important aspect by which the company is measured by its farmer-shareholders, but it is not the only one. Fonterra needs to be constantly communicating with farmers, informing them what the company is doing and why it is doing it. Specifically related to the topic of this thesis, Fonterra has to communicate with farmers (within commercially-sensitive boundaries) the details, implications and logic behind its portfolio of international investments.

As the international businesses of the company has become increasingly complicated with JVs, marketing agreements and alliances in place, the company needs not only to communicate but also to explain these issues to farmers; therefore communication has strong links with education, as information transfer and knowledge transfer are often synonymous. In other words in most cases while the company is communicating it will be also educating its shareholder base.

This new communication reality that Fonterra is facing represents a change to historical communication schemes used by major New Zealand co-operatives and the New Zealand Dairy Board in the past, where in fact farmers were one step further away from the international marketing of their products and as a consequence it can be said that in general terms they were less aware of the NZDB's international movements.

Communications at Fonterra are basically handled at two levels and by two different entities, Shareholder Services and Corporate Communications. The Shareholder Relations department at Shareholder Services is responsible for basically all communications that go to farmer-shareholders except for the Annual Report. Corporate Communications on the other hand are responsible of the Annual Report, but also of all company's communications to the media and the businesses around the world³⁴.

³⁴ By the time this report was being written, in October 2002 newly assumed chairman Henry van der Heyden announced that communications between Fonterra and its stakeholders was going to be contracted out to professional agency Baldwin Boyle Group.

A very important aspect in terms of the company's communication with its shareholders is that everything the company communicates externally (i.e. to the media) has an impact on shareholders. At the same time, because Fonterra is New Zealand's biggest company, the media and the general public has an obvious interest in everything related to the company and also because Fonterra has capital notes listed in the New Zealand Stock Exchange the company is forced to publicly inform of major changes causing that sometimes Fonterra's shareholders may receive information about their company through the media (TV, radio, newspapers) first than through the company's internal communication mechanisms.

Fonterra's first year of life has not been free of communication problems with its farmer-shareholders and the newly assumed Chairman's decision of contracting out the company's communications is a sign of it. Also, on the other side, the relationship of the company with the media has not been optimum either and it can be argued that it could have been handled better, although the company and especially its shareholders have to understand that they are going to be always in the eye of the media. Finally, while constant communication is something that Fonterra needs to do in order to keep their farmers informed, the company must pay attention to the amount and kind of information sent to farmers, making sure farmers do not to turn off their ears due to an excessive amount of information, therefore a balance is needed.

"Over the last months we have done quite a lot of communication but what has happened is that with the merger and being the first year of operation, the company has been sending so much information to the farmers that farmers have gone off, they haven't been reading a lot of the stuff that is going through and we need to turn that around" (Rodd Hodgson, Fonterra Shareholder Services, personal interview, August 2002).

Among the various internal communication mechanisms, face-to-face, printed and electronic, that Fonterra has in place for communicating with its farmer-shareholders, the most important ones are listed and briefly explained below:

4.7.1.1 Face to face communication mechanisms

(I) Annual General meeting (video-linked). The Annual General Meeting (AGM) represents the main opportunity for shareholders to receive reports on financial and operational annual results and topical issues directly from their leaders (Chairman and CEO). At the AGM farmers-shareholders also have the chance of challenging their governors about the direction of their company. Due to the size of the co-operative and the geographical dispersion of its 13,000 farmers-shareholders (plus 5,000 share-milkers) the AGM is simultaneously held at seven different venues, with the Chairman and Executive Management Staff present at the main venue and Directors spread among the others. The use of video-linking technology³⁵ has been successfully implemented by the company and proved very useful in the AGM to enable increased shareholder participation. Also at the AGM, shareholders vote on major issues.

(II) Governors/farmers meetings. Directors have meetings with shareholders three to four times a year on a regional basis. Presentations are normally spread between two Directors, with usually no more than 100-200 farmers attending at each meeting. Directors meetings are mainly aimed at Directors communicating the direction and performance of the company to its shareholders, but also about the Directors getting feedback from them on key issues. Directors meetings represent also the main (and probably only) opportunity for shareholders to somehow evaluate their elected Directors for future re-election purposes. Senior executives (CEO, CFO and Managing Directors of the main business units) also participate in meetings with shareholders, although less frequently.

(III) Supplier meetings (Shareholders meetings). Meetings are held within the different wards focusing on different subjects; these meetings again, could involve Directors and senior executive managers, but they could also involve other key individuals at Fonterra and even people from outside the company. Besides communication, the logic behind these meetings is the generation of discussion within the shareholder base around topical issues and finally to take farmers' majority views back to the Board of Directors through the Councillors.

³⁵ Video linking technology is also being used for election of Directors.

(IV) Supplier networks. Although the primary role of supplier networks is to work as an upward communication mechanism (shareholders-Councillors-Directors), it also operates to some degree as a downward communication mechanism (company-Councillors-shareholders) and also as educating and up-skilling mechanisms. As already mentioned, each one of the Council members has established supplier networks within their wards, operating in different ways. According to the Council a total of 380 farmer-shareholders are involved in Supplier networks. The number, which represents 3% of the total shareholder population, can be considered low and the expansion of these networks is definitively one of the areas that the company, and specifically the Shareholders' Council, need to work on.

In general terms the way supplier networks were established was through an open invitation to all shareholders to participate in a network within their Wards in order to be in regular contact with their Councillors. After that, individual Councillors organised networks in their wards independently according to responses, personal preferences, etc. Therefore, some networks operate through regular structured meetings, others through occasional meetings and some others strictly through email. Farmers' involvement in networks range from a hundred to a few, depending on the wards. Several reasons can be found for the differences among wards, including history and tradition of networks between the different areas.

It is interesting to highlight the approach of the Councillors from one of the most network-active wards in Fonterra, having in fact three networks within their ward: *"Notices went out for all our shareholders, but we actually went out ourselves and approached the people and said to them, we want you to be part of our network, and we do know the key people in the area and the key people that are valuable to have on a network like that"* (Brian Power, Fonterra Councillor, personal interview, September 2002).

4.7.1.2 Printed communication mechanisms

(V) Annual Report. The Annual Report is a document sent to all shareholders summarising the company's key figures for the year, information about the company's national and international operations and detailed financial information of Fonterra Group. The Annual

Report also goes to businesses and partners worldwide, therefore representing also a business and marketing tool. As with most Annual Reports, electronic versions can also be downloaded from the company's website.

(VI) Shareholders' Council Report. The Shareholders' Council Annual Report is a totally independent document sent strictly to all farmer-shareholders in which the Council gives detailed information about the Council activities over the last year and more importantly, a detailed analysis of the Co-operative's operational and financial performance, fulfilling in that way its role of performance monitoring. Coming out at about the same time as Fonterra's Annual Report, the Council Annual Report represents a very unique document. The first year Council Report analysis went in detail through the merger benefits achievements, financial (balance sheet) situation, and major business units' performance (NZMP and New Zealand Milk). Also the report includes the Council program and budget for the coming year.

It is probably accurate to state that the Council Report is maybe the most visible output of the Shareholders' Council and to a great extent the reason for its existence, although it may have a double effect on farmer-shareholders, generating a feeling of amazement (and even pride) about the level of transparency and independency among governing and representing bodies of their co-operative, but at the same time a feeling of despair about their company's performance.

(VII) Farmlink Magazine. Farmlink is a monthly supplier newsletter under a magazine format sent to all shareholders. Farmlink includes regular letters from the Chairman of the Board, the Chairman of the Shareholders' Council, and a section of Shareholder Services, as well as news and international market overview among other sections. The Magazine, prepared by Shareholders Services represents the main regular communication mechanism used by the company³⁶.

³⁶ It costs \$2.48 to produce and mail through regular post one copy of Farmlink against \$0.78 to email it. Still, on a survey done by the company 77% of surveyed farmers said they preferred to receive the newsletter via the post as opposed to reading it through the Internet, showing that price is not the only aspect taken in consideration.

(VIII) Letters to farmers. Besides the structured printed mechanisms, like the Annual Report, the Council Report and Farmlink, letters from the company, the Board of Directors and from the Shareholders Council are sent to all shareholders covering topical issues during the year as necessities arise.

4.7.1.3 Electronic communication mechanisms

(IX) Fencepost.com website. Fencepost website gives web-based information services to all shareholders through an exclusive shareholder site, including milk quality and production data (current and historical), farm management tools, company communications and other company information and documentation. The website also allow farmer-shareholders to access letters and weekly/fortnightly updates from the Chairman and CEO.

According to the company, by July 2002 Fencepost had 42% of New Zealand's agricultural web traffic, achieving more than a million page views per month. The website also operates as an open rural and agribusiness website at www.fencepost.com. Complaints have arisen from certain farmers, as limitations exist for their use of Fencepost due to rural access and downloading speed problems. Finally, the intake of new technologies is not as fast as the company would like because the 'conservative nature' of farmers.

(X) Fonterra's website. A very complete and recently revamped company's website (www.fonterra.com) offers company information, industry news, constantly updated international markets reports and company's official statements among many others.

4.7.1.4 Other communication mechanisms

Although the previous list tries to describe the main mechanisms Fonterra uses to communicate with its farmer-shareholders, it is not a totally inclusive list. Other mechanisms include field days, casual meetings of Directors or Councillors with small groups of farmers, appearances of Councillors, Directors of the Board and senior Executives in industry events,

public speeches, etc. All of these represent communication mechanisms and help to build to the same degree, if not greater, co-operative's culture and ownership feeling.

The NZMP Farmer of the Year Contest represents an extremely good example of an integrative mechanism by which a co-operative like Fonterra can differentiate itself from competitors (IOFs), get closer to its farmer-shareholders and to certain extent improve the efficiency of its supplier base. From the farmers' point of view the contest represents an incentive for improving production and efficiency, substantial economic rewards (\$300,000 for 2002 Farmer of the year contest, big part donated by sponsors) and the prestige it implies being a 'Farmer of the year Winner'. The contest integrates farmers with the company and it is an incentive for farmers to perform in the areas of financial management, staff management, environment and animal welfare issues among others.

"Our farmers are world leaders in on-farm productivity and this, along with our quality focus, gives us a competitive edge in the marketplace. This competition is about recognising the cream of the crop and sharing their experience across the country" (Chris Moller, Managing Director NZMP, Farmlink, November 2001, p.8).

4.7.2 Education and up-skilling

"The biggest danger is that if we don't educate suppliers, they will vote and react for the wrong set of reasons rather than rationale reasons, so it is in the co-operative interests to raise that knowledge level" (John Monaghan, Fonterra Councillor, personal interview, July 2002).

The education and up-skilling of farmer-shareholders can happen on different fronts such as technical up-skilling of shareholders through Field Representatives and Milk Quality specialists on a day-to-day basis or in Field days, improving the production efficiency of the co-operative's suppliers and therefore the efficiency of the company, an issue that is tremendously topical for Fonterra based on the fact that the suppliers' production efficiency

represents one of the key strength of the company. Although, this study focuses on the education of farmer-shareholders in terms of the understanding of the company's functioning and the environment in which it is immerse.

By educating shareholders about the company: first, it elevates the level of understanding of the co-operative's shareholder base, which situates the company in a better position for undertaking the strategic changes that are becoming increasingly frequent, with the support of its shareholders. Second: it raises the level of knowledge of shareholders who in turn become able to question Directors on strategic and background issues rather than superficial ones, elevating the discussion level of the co-operative as a whole, eventually leading to raise the efficiency of the company. Third, by educating its farmer-shareholders, the company creates a pool of highly skilled people to eventually become future leaders (i.e. Councillors, Directors), which again, is in the best interest of the company. Traditionally in New Zealand, dairy co-operatives the filtering of leaders occurred through small co-operatives whose leaders ended up in the New Zealand Dairy Board. Dynamics have changed, that natural filter does not work in the same way anymore and the formation of leaders is a key challenge for Fonterra.

The education and up-skilling of farmer-shareholders should cover the whole range including current Directors, Councillors and farmers without any representative or governing position. Directors at Fonterra receive further training once they become elected. Among the current farmer-Directors, background education includes governance courses of the New Zealand Institute of Directors, governance and management courses overseas (Switzerland, France, US) and co-operative specific courses among many others. Directors, more than anybody else in a co-operative, need to be constantly up-skilling, to meet the business requirements.

In terms of the education of Councillors, the Council has a limited amount of funds available for the training and up-skilling of Councillors. Councillors apply on a case-by-case basis to receive money for attending specific courses. Also, Councillors just like all shareholders, are eligible for the Industry Training Program, as will be seen later. In addition, the interaction between Councillors with the Board, Senior Executive Managers and special speakers at Council meetings represent an informal but important educating mechanism.

Finally the education and up-skilling of farmers occurs through several avenues. Again, most of the communication mechanisms previously mentioned like governors/farmers meetings, supplier meetings, supplier networks and the Farmlink magazine, work also as education mechanisms, which if effectively elaborated raise the level of knowledge and understanding of the farmers-shareholders. So for example, supplier networks, although mainly intended as an upward communication mechanism, also work (at least in some wards) as a meeting venue, where interested farmers go reasonably frequently to learn about the co-operative.

4.7.2.1 Industry Training and Personal Development program

Fonterra's 'Industry Training and Personal Development Programme' is the company's main education mechanism. The program follows two objectives, elevate the knowledge of the co-operative and work as a catalyst for those people who might want to go into further Directorship and governance representation roles within the co-operative, who if elected are quickly able to make a positive contribution.

The programme is made up of three stages:

(I) Introductory programme: Open to all shareholders³⁷, it consists of a two-day program that covers an overview of the company and its business units as well as the dairy industry environment. During these sessions Councillors, Directors and senior executive managers from Fonterra's key business units make presentations to small groups of 30 participants, explaining the functioning of the company in New Zealand and overseas. By September 2002, two introductory program sessions had been held, with approximately 100 shareholders participating.

(II) Intermediate programme. Stage 2 consists of a range of courses (MBA, Kellogs Course, etc) lined up for selected farmers to assist. Stage 2 and 3 of the program are administered by an external human resources firm (currently Deloitte Co.) that selects the

³⁷ Participants are required to make a financial contribution (\$100) for the program, which works more as a commitment fee rather than covering the program costs.

most suitable candidates through an assessment centre. The program is still in the development phase.

(III) Advanced individualized programme. Eligible for the advanced programme are the 46 existing Councillors, ex-Directors and ex-Councillors and participants of the two previous stages of the training program. Also administered by an external consultant firm, stage three consists of individualized development programmes for a reduced number of selected farmers, which aim at developing governance and representing skills.

Although Fonterra's main two drivers are to give shareholders the best return on their money (through the FVS and the payout) and to give them a premium service, there is a growing recognition of the importance of the education and development of the shareholders and although Fonterra is in the early days of development of members' education programs, the Industry Training Program is evidence of a commitment to education.

4.8 Implications of the internationalisation strategy adopted

4.8.1 Advantages

"It is clear from the research that there is a strong incentive for firms to internationalise, since there is an established link between the degree of internationalisation of a firm and its financial performance" (Enderwick & Akoorie, 1996, p.102).

The advantages that co-operatives such as Fonterra can gain from internationalisation are almost the same as those that apply for IOFs, including continued growth, achievement of economies of scale and scope, strengthening of competitiveness, utilisation of know-how, access to bigger markets, risk diversification and ability to seek resources abroad (Buccola et al. 2001; Federation of Danish Cooperatives, 2001).

Although it is not the objective of this project to analyse in depth the advantages of internationalisation, the following list tries to briefly describe the most important advantages for Fonterra and its farmer-shareholders of the adopted internationalisation strategy:

(I) Achievement of economies of scale and scope

By increasingly expanding into overseas markets through FDI, JVs and alliances, Fonterra can improve its competitiveness through increased access to economies of scale and scope, lowering its average costs of production and therefore increasing returns for the company and therefore to its farmer-shareholders.

“These factors (the achievement of economies of scale and scope) and the opportunity to escape the constraints of a small domestic market emerges as the most important motive for the internationalisation of New Zealand business” (Enderwick & Akoorie, 1996, p.130)

(II) Capabilities and infrastructure optimisation

As previously seen Fonterra has certain firm-specific capabilities, namely low-cost farm productivity, large-scale milk procurement, processing, and product development. The exploitation of these capabilities across a wide range of markets has the potential to significantly increase returns without significantly increasing costs. At the moment Fonterra is utilising only its collection, processing and R&D capabilities in other markets besides New Zealand.

By having a vertically integrated global structure, Fonterra’s production resources are optimised, R&D used more effectively and advertising and promotion spent more efficiently.

Also by establishing JVs and alliances Fonterra aims to maximise existing infrastructure. For example, the Fonterra/Nestlé alliance did not mean an increase in capital invested in the Americas by Fonterra; instead, it represented the addition of about the same amount of capital and infrastructure by these two companies in order to increase their efficiency and as a result improve both partners’ competitiveness.

(III) Access to key resources

Rabobank (2002) identified that even though world dairy supply is increasing by around 1% per annum, world demand for dairy products is growing at 2% per annum, creating concerns among dairy companies about securing sufficient raw product (i.e. milk). As a consequence, control over milk supply at a global scale, gained through investment in overseas processing plant and external sourcing of milk, may prove critical for Fonterra and eventually situate the company in a competitive advantage position in terms of being able to offer to its customers a secure no-disruption supply of dairy products.

Raw product (milk) is not the only resource that Fonterra is securing through internationalisation. Key labour and marketing skills, and technologies among other factors that Fonterra secures to a certain extent with its global knowledge network. Also, as the multinational nature of its staff proves, people are a key resource that Fonterra is in fact securing (as described in subchapter 4.4.6 above).

(IV) Access to markets and buyers

Fonterra needs to increase its market share in the wealthier markets of Europe, South East Asia and North America as well as the growing markets of Latin America. By internationalising beyond the initial stage of exporting, Fonterra is able to enter into these markets and also to supply global customers from global sources.

By investing and controlling the overseas distribution chain, Fonterra gains proximity to customers receiving market information and being able to respond faster to signals; also, as an internal market with a flow of intermediate products and branded goods is created, an increment of dairy products of New Zealand origin results, as in the cases of the acquisitions of the Mexican cheese and spreads businesses and the Dairy Partners Americas (DPA) alliance³⁸.

Finally, more evolved FMSM such as FDI, knowledge agreements and alliances allow Fonterra to overcome the restrictions imposed by trade barriers, which are considerably high

³⁸ Fonterra will be DPA's preferred supplier.

in the dairy industry, increasing its markets share in otherwise closed or capped markets. Also by having a strong presence in key markets like Mexico and Brazil the company locates itself inside trade blocks such as NAFTA or Mercosur, therefore gaining a strategic competitive position.

(V) Reducing and diversifying risk: stabilisation of revenues

Fonterra is effectively reducing risks by several means through its internationalisation strategy. Firstly, by following JVs and alliances arrangements for servicing foreign markets, neither Fonterra nor its partners (JV partners or alliance partners) bear the full risk and cost of the joint activity, so these FMSM can be considered risk-bearing mechanisms.

Also by diversifying from being a simple exporter of commodities and following a foreign investment strategy, Fonterra is to some degree reducing the volatility of the commodity cycles, in other words the company is less subject to drastic changes in its returns, therefore the revenues of its shareholders are also more stable.

(VI) Financing and capital structure advantages

By using JVs and alliances Fonterra is able to follow a more aggressive expansion strategy than it could achieve by itself, having access to capital and knowledge from partners without sacrificing (totally) the control of these ventures.

In terms of the capital structure, from the shareholders' point of view, the advantages are related to the fact that all the value created in the process of investing overseas (if investments are successful) has an impact on the company's total value, which is reflected back to shareholders through the Fair Value Share. When leaving the company or decreasing supply, shareholders have access to that capital (value) created.

It is interesting to note the impact of this value-creation process over farmers' long-term returns: *"Once farmers got their shares they've got them forever and dairy farmers have always looked long-term rather than short-term. Most dairy farmers also strived to increase production to add long-term capital value to their properties. Most dairy farms are sold at a*

value that includes its production potential” (Chris Welch, Dairy Farmers of New Zealand Southland Chairman, The Southland Times, 21 August 2002).

(VII) Global scanning and learning (access to knowledge)

The ability to learn from international exposure and opportunities through its global network of subsidiaries is one of the greatest advantages of Fonterra’s internationalisation, and probably one of the least exploited.

“...offshore subsidiaries must act as the sensors of new market trends or technological developments wherever they occur; they must be able to attract scarce talent and expertise on a worldwide basis, tapping their knowledge to develop creative responses to the merging opportunities and threats; and they must be able to act collectively with other subsidiaries to exploit the resulting new products and initiatives worldwide, regardless of where they were originated” (Bartlett & Ghoshal, 2000, p.618).

4.8.2 Risks and potential conflicts

(I) Possibility of failure of foreign investments

Maybe the most obvious risk that must be considered when analysing a strategy of foreign investment, like the one Fonterra is currently pursuing, are potential failures in overseas businesses, which in the case of Fonterra are a very significant part of the business. The company, and specially its shareholders, must acknowledge that when following an aggressive foreign investment strategy, not all investments will be successful.

Fonterra has property, plant and equipment assets of \$3.9 billion plus \$380 million in investments, that is over \$4.3 billion (without considering the intangible assets) of which a considerable part are invested overseas.

The risks of making poor investment choices must be acknowledged, and investments must be analysed independently as well as in the context of Fonterra's investment portfolio. As investments increase so do the risks. Fonterra has been very active in the past year in establishing new overseas businesses (acquisitions, JVs and alliances). If a substantial part of these investments are not successful, the company will be losing money and losing value. The implications of this are several and from the shareholders point of view it will be reflected at the FVS and/or the payout, with the company running the risk of losing suppliers against a competitor that has followed a different strategy.

Also, it has to be kept in mind that the adopted FVS structure has several benefits in terms of the transparency of the company's performance and the fair value that newcomers and retiring farmers receive for their share in the company, but the counterpart is that any substantial loss of the company in overseas business is almost immediately reflected in farmer-shareholders' shares value.

The strategy therefore requires great discipline and control mechanisms to ensure that investments are actually adding value. It is assumed that Fonterra has them, although it is difficult as an outsider to evaluate that. Besides Executive Management, the Board of Directors receive detailed reports about the financial performance of the overseas' investment portfolio. Therefore it can be said that a triple-layer control exist, first at the subsidiary's Manager level, then at Senior Executive level in the Corporate Centre and finally at Directors' level.

(II) Dilution of Control

One of the trade offs of collaborative FMSM (i.e. JVs and alliances), is related to control dilution. For example, in Fonterra's JV with Arla Foods in the UK, Fonterra owns only the 25% of the new business, while Arla Foods owns the remaining 75%. As already seen the advantages of that kind of arrangements are considerable for Fonterra both in terms of the capital as well as know-how contributions from the partner, but on the other hand the control over the strategies to be implemented in the new business is not exclusive to Fonterra anymore.

The same applies to other FMSM and overseas business entered, especially in the case of partnerships with bigger and more powerful partners like for example the 50:50 alliance with Nestlé in the Americas. The growth potential for Fonterra in the Americas under this umbrella is significant, but the dilution of control, as well as other risks that will be analysed later, are also present and must be acknowledged.

Control dilution is something that has to be acknowledged by any company when entering into JV, knowledge agreements (licensing) and alliances. These three forms of FMSM imply significant advantages, especially for co-operatives where capital limitations are in the majority of the cases the biggest barrier for internationalisation, but at the same time imply a degree of control dilution. A key point in this respect is the alignment of the partners' strategic objectives; in the absence of this, potential conflicts are likely to arise.

(III) Real or perceived competition between New Zealand shareholders' dairy products and externally sourced product

External sourcing of milk can become an un-easy situation for Fonterra if competition concerns arise from its farmer-shareholders. The tension is not new for Fonterra as the company has been sourcing non-members milk for an extended period, but as Fonterra's international businesses have become more complicated there are areas where competition conflicts could be perceived by Fonterra's shareholders.

For example, the recent formation of the trans-Tasman consumer business AFHL, although generally supported, generated some concerns on both sides of the Tasman Sea³⁹ regarding competition and cross subsidisation. In the same way, other overseas business like Fonterra's marketing agreement with Dairy America for exporting skim milk powder (SMP) out of the US can become potential sources of conflict if besides paying attention to the business soundness of the venture, the company does not take care of the farmers' perception and

³⁹ Following the announcement of the formation of AFHL, declarations from Victoria dairy farmers president, Peter Owen, and NZ Dairy farmers chairman, Kevin Wooding (fencepost, 02/07/2002).

understanding of the venture. In other words the deal does not only have to be fair, it must look fair.

Fonterra must ensure the efficiency of appropriate mechanisms to deal with competition between its different subsidiaries in a way that the overall business is benefited. Not only that, Fonterra has to be able to explain to its farmer-shareholders in first place, and to its overseas partners (e.g. Bonlac Supply co-operative's shareholders) in second place, that these mechanisms exist and in simple terms how they operate.

Referring to the issue, Harry Bayliss, who is Director of Fonterra and also Director of the Australian co-operative Bonlac Foods, commented: *"We need to be able to explain not only to our farmers but also to Australian farmers in fact that we've got systems that ensure that we are able to get benefits out of the relationship, and there is no one group that is being advantaged in the detriment of the others"* (Harry Bayliss, Director of the Board, personal interview, July 2002).

In general terms Fonterra has not dealt with a great amount of concerns from its shareholder base in respect to offshore production competition and the communication with its farmer-shareholders, through its various channels, has apparently been effective in this topic. Still there is room for improvement, especially in terms of explaining to its farmer-shareholders how the aforementioned mechanisms work.

(IV) Real or perceived deficient service to supplier-shareholders

An area where Fonterra has to pay special attention is in maintaining and improving its service level to its supplier-shareholders in New Zealand while pursuing a growth strategy overseas. If Fonterra's farmer-shareholders in New Zealand perceive (correctly or incorrectly) that the company is giving more attention and focusing more resources to its overseas businesses than to its supplier-shareholders, and therefore owners of the business, a disconnection, what is called 'disenfranchising', with fatal consequences could happen.

Fonterra has two main objectives as a dairy co-operative: (1) maximise value (present and future) for the company and its shareholders and (2) provide a quality service to its farmer-shareholders. One cannot take place at the detriment of the other.

The Shareholders Services department plays a key role in the service-delivery area, because as already seen, Field Reps, operators at the Contact Centre and milk specialists, are the first face and voice farmers deal with in the day-to-day. Still the task is not their exclusive responsibility, as the whole company must build co-operative spirit, developing ownership feeling among farmer-shareholders; in other words, make New Zealand dairy farmers want to belong to Fonterra.

The risks associated with a poor service (or perception of poor service delivery) are that as the New Zealand dairy industry is now deregulated, new dairy companies looking for suppliers can and probably will get installed in the country. At that point in time, farmers will choose whether to stay or switch based on milk payout and service level. Also, by having an unhappy shareholder's base, the company will lack the support for strategic initiatives, capital raisings and other key initiatives that the company could undertake in the near future.

In simple words the company must have a premium service delivery to its farmer-shareholders, it must collect their milk on time, it must provide timely information, etc. During its first year Fonterra experienced service problems and concerns from its farmers: *"We are not getting the service we had before and the liaison with the company is not good. Fonterra would have to put in a lot of effort to rebuild its damaged relationship with shareholders and to lift its performance"* (Kevin Wooding, Dairy Farmers of New Zealand Chairman, The Dominion Post, 8 August 2002).

In order to face the experienced service problems, Fonterra, among other things, restructured its Shareholders Services department in August 2002, reorganising areas and spreading workload (see Figure 10).

Milk collection was a critical problem for Fonterra in its first year of life. The implementation of a new tanker scheduling system to optimise collection and therefore minimise transport

costs, caused problems in on-farm service levels: *“the rationalisation of milk collection operations and the handling of milk from plant breakdowns are key achievements for 2001/02. The cost to some suppliers however is revealed in statistics which show an excess of 3,500 late off-farm milk collections occurred in the month of October 2001 alone”* (Fonterra Shareholders’ Council Report, p.13).

The Council’s words infer the existence of a small conflict, service level vs. payout. In order to be as efficient as possible and maximise payout to shareholders, the Transport department (under NZMP) need less tankers, which in turn can generate some service delivery problems to be faced by the Shareholders Services Department. This can be extrapolated to the whole range of services that Fonterra provide or could eventually provide to its supplier-shareholders. So for example Fonterra could implement a service totally personalised or increase the numbers of assistants in its Contact Centre, or increase its number of milk quality specialists, but all these services will have a cost, and that will come out of the shareholders’ payout.

In order to put the service delivery problems experienced on the first year in context, it has to be understood the massive integration process that Fonterra passed through, in terms of integrating three of the largest companies in New Zealand into the largest one. Doing a review of Fonterra’s first year of life, the Deputy Chairman of the Board summarised it in the following way: *“I think it is the 80:20 rule; the 80% is there and working well, we are still loose around the edges, that’s how I would describe it. And I guess we always knew it was going to take a while and it is taking a while to get the right systems and the right people in the right jobs”* (Greg Gent, Deputy Chairman of the Board, personal interview, August 2002).

It can be said that the 20% that did not work perfectly is closely related with the service delivery to its supplier-shareholders and this is the area where Fonterra has to work strongly and quickly, specially considering that the payout for the coming season (\$3.70) will be significantly lower than the \$5.33 of 2001-2002.

It has to be understood, that it is very likely that farmers would be more concerned about local check payments or milk collection problems or any other small-scale local problem, than the

signing of international business alliances, although the second has definitively a bigger impact on the company's overall performance. If supplier-shareholders in New Zealand are discontent with the service level they are receiving from the co-operative, it is likely that they will reflect this through their voting like, for example, removing current Directors standing for re-election, which in turn may play against the co-operative's performance at a global scale due to the continuous rotation of Directors. Therefore, service delivery and service delivery perception at the local side is a key aspect in the process of internationalisation.

(V) Distancing of farmers

Rabobank (2001a) stated that dairy companies' managers face potential conflicts if: (1) focus on the farms and pay little interest to the necessary strategic changes that the company must do; (2) focus on the food industry and the development of strategies with too much distance between the co-operative firm and the farm. Rabobank described the two mentioned factors as pulling in opposite directions.

Based in the information gathered, in the case of Fonterra, the distancing of farmers can be the result of the combination of the following factors:

- Company size
- Lack of understanding from farmer-shareholders
- Low participation levels
- Governors (Directors and CEO) and farmers distancing
- Other factors

In large co-operatives like Fonterra shareholders can feel very distanced from what is happening in the Boardroom, becoming suspicious of the company's activities, with the situation getting worse if they do not understand the business; in other words all the above mentioned factors interact with the final consequence of farmers getting distanced. The appropriate integrative structures together with communication and education play key roles in terms of fighting and/or avoiding farmers' distancing.

a) Company size component

By any form it is measured Fonterra is a large company. It has over 13,000 farmers-shareholders, about 20,000 employees, over 90 subsidiaries and associated companies around the world, etc. The implications of its large size are several and affect all aspects of the company. From the farmer's point of view:

"Some shareholders have quite clearly said that they feel as such a small part of it now, do they matter anymore, does it matter what they think, they are not sure they can have any influence over direction anymore because it is such a big business. I personally don't agree with those that feel that way, I think everyone can have an influence providing that they have got an intelligent input and sometimes an intelligent input is just asking the right questions" (Malcolm Bailey, Fonterra Councillor, personal interview, July 2002).

The rationalisation process that led to the formation of Fonterra happened at the cost of stretching the distance between farmers spread around New Zealand and the company, with its headquarters in Auckland. At the same time farmers' operations have also become bigger, more efficient and more demanding in terms of time, therefore the communication between this huge company and these larger farmers has become difficult.

Beside the mentioned service problems that Fonterra experienced in its first year of operations, the company also experienced some difficulties in terms of communications with its shareholders, with communication being described as deficient by farmers' representatives.

"A really good example of how difficult it is to reach 13,000 geographically dispersed individuals is the annual report. On Sunday night, we posted it out, some of our people would've got it Monday morning, but the remainder wouldn't have got it until Tuesday morning because of the way rural post works. In the middle there is huge media interest. So, late in the afternoon on the Monday we had a media conference, and some of our shareholders potentially didn't have the annual report by then" (Jodie Stewart, Corporate Communications Manager, personal interview, August 2002).

Also related to the company's size, is the fact that in the case of Fonterra, being the largest company in New Zealand, it is not totally unlikely that farmer-shareholders could find important things about their co-operative through the media first. Also as the company has capital notes listed in the New Zealand Stock Exchange (NZSE), it is obligated to announce any major initiative that could impact the bottom line of the company publicly first. Due to the mentioned capital notes, Fonterra must report to the NZSE all financials and key governance issues and even key business deals, like for example major international alliances (i.e. Dairy Partners Americas), creating a tension with farmer-shareholders that historically have been used to receive that kind of information before the general public would.

The challenges that Fonterra is currently facing are how best to communicate and what channels to use, meeting statutory requirements as well as trying to maintain the principals of the co-operative. In terms of the channels, although electronic channels would probably be the most efficient way to reach 13,000 dispersed shareholders, the facts are that only about 40% of them are on the Internet and that current access and downloading speed in rural areas in New Zealand is deficient. Although a recent company survey showed that the majority of farmer-shareholders do not want to receive information by Internet or email, the huge potential benefits that electronic channels have for communication purposes sets a challenge for Fonterra in terms of developing the friendliness and convenience of its web page and also to convince farmers of the mentioned benefits.

b) Lack of farmers' understanding

The second source of potential distancing of farmers from the company can be their lack of understanding of the business and the company's strategy. It can be argued that at this specific point in time the complexity of the business is itself a far more important and risky aspect than the size component for Fonterra. Again communication and education play key roles in avoiding farmers distancing as a consequence of a lack of understanding. Also, at the same time that farmers' knowledge level is raised, co-operative's governors, managers and staff should be trained and their communication skills improved (e.g. dismiss of highly-technical language). Communication implies the exchange of information or ideas; therefore, there has

to be a common language that both the sender and the receiver understand. These two factors, if addressed together, should have the effect of overcoming the lack of farmers' understanding issue, bringing them closer to the co-operative.

Fonterra has initially concentrated its communication efforts and resources (e.g. booklets, meetings, workshops) on explaining to farmers the new capital structure and the new economics, as they have proved hard to assimilate by farmers. So far the same cannot be said about the internationalisation strategy of the company and the implications it has over the business as a whole and to them as individual suppliers. Fonterra has to be able to explain in simple terms so that farmers understand the strategy being followed. If the company is not able to explain in simple terms virtually everything the company does onshore and offshore and the reasons behind it, farmers will eventually get distanced.

Specifically focusing on the topic of this project, growing internationally without generating conflicts mean that Fonterra must ensure that farmers-shareholders understand the global dairy industry, what it means for them and their business, and what is the company's strategy accordingly. On the other hand, Fonterra must be careful not to saturate its farmer-shareholders with an excessive amount of information; therefore a balance is necessary.

As the company heads into its second year of life, it must start a process of communication, education and consultation regarding the challenges ahead in terms of the internationalisation of the company, the adopted strategies (e.g. the strategic alliance with Nestlé) and the implications to the business in order to broaden the level of understanding of the shareholder base. The first step in that process is supposed to be Project Galileo.

c) Low participation level

Low participation can be considered both, a cause and an effect of the distancing of farmers. It is very important for a company the size of Fonterra to make its farmer-shareholders feel that they are an active part of the co-operative. If farmer-shareholders lose interest and do not actually put the time into attending meetings, exercising their voting rights and listening from

a primary source (Directors) about the direction of the co-operative, the risks of distancing are high.

In the special meetings of July 2002 to approve constitutional changes, only 20% of Fonterra's 13,000 shareholders attended to vote. Some of the issues that were voted at that meeting were significant, like the inclusion of sharemilkers as shareholders of the company. That attendance level represented a huge drop from the 85% attendance of previous meetings. The challenge for Fonterra is to lift those numbers again.

The reasons for low voting attendances are probably not exclusively in the distancing of farmers, with timing issues and the excessive amount of activities that farmers were involved in over the previous months among others also having an influence. Also, it has to be recognised that as farms have become larger operations there are times constraints for farmers that probably did not exist before. On the other hand this same increase in farms size implies that most farmers employ farm staff, therefore he/she should have a greater availability to participate in activities out of the farm. In sum, dynamics have changed and all farmer organisations like Fonterra must take that into account.

The low percentage (40%) at the Dairy Insight voting in May 2002, which decided the funding of New Zealand dairy industry activities irrespective of the co-operative, is a sign in that respect. Still, it cannot be denied that the low levels of attendance to voting meetings as well as the low level of farmers' participation in some of the suppliers networks organized by the Shareholders' Council are signals of distancing and disenfranchising between the co-operative and the farmers, that the company must be extremely aware of.

In terms of the relatively low participation levels of farmers-shareholders in supplier networks (specially in determined regions), the reasons, as already analyzed, can be found in the lack of a network tradition in certain areas of New Zealand as well as in the same time constraints attributed to low voting attendance. Supplier networks are a unique and key component of Fonterra's structure and one of extreme importance in avoiding disenfranchising; if farmers do not actively participate in them, the risk of distancing increases. From the farmers' point of

view, in order to want to belong to a network they have to feel that it is worthwhile being part of the network.

d) Governors / shareholders distancing

Rationalisation into one large dairy company (Fonterra) with its Boardroom in Auckland and its Directors elected on a national basis rather than a district/regional basis, has implied a drastic change for New Zealand dairy farmers. Less than 10 years ago there were several dairy co-operatives in New Zealand and dairy farmers had almost daily interaction with their local Directors. Dynamics have changes and that disconnection between farmers and governors, especially Directors, is a factor that if not dealt with properly, can become a reason for farmers to feel remote from their company.

Fonterra has determined that Directors will remain responsible for communicating to shareholders the company's strategy and key initiatives, ensuring that the interaction between farmers and Directors is not restricted to the AGM. Councillors are mainly responsible for the upward communication, collecting shareholders concerns and points of view and presenting them to the Board of Directors. In that respect Councillors become the link between shareholders and Directors. In a co-operative with 13,000 shareholders and 10 elected-Directors the existence of a representative body is the only feasible alternative.

The same concept of distancing applies, although to a lesser extent, to the company's key executives (i.e. CEO). In August 2002 after the company's annual report was released, Fonterra received a considerable amount of 'bad publicity' regarding the salaries of its senior executives, with the associated risks of distancing and generation of tension between farmer-shareholders and governors: "*Fonterra's CEO Craig Norgate is on the \$2 million a year, and eight of his lieutenants receive more than \$1 million. Dairy farmers learnt from Fonterra's first annual report yesterday that while they are being told to tighten their belts, millionaire managers are being created at the top of their co-operative*" (The Dominion Post, 13 August 2002, p. A1).

Fonterra must explain to their shareholder that as the company has become a global player operating in a complex environment, it needs top executives and top Directors to run the business and if Fonterra does not reward its executives according to the market, it runs the risks of suffering brain drain.

VI) Directors' governing/representing conflict

The previous point of distancing of farmers from Directors leads to the generation of a potential conflict in the Boardroom. In a company like Fonterra farmer-Directors face a conflict between representation and governance, because although they are farmer-elected Directors hence they are representatives of shareholders, their prime role once they get to the Board is to govern the business. As a consequence, elected Directors are not involved in their local communities anymore, and as already mentioned, that disconnection between shareholders and Directors introduces risks. The situation gets magnified in a company the size of Fonterra (company size component) and with the complexity of its international business network.

Depending on the different points of view, schools of thought and the corporate or co-operative tendencies, opinions differ on whether Directors should spend more time, or the totality of their time, at the governance level (running the company) or the representing level (meeting with shareholders).

Fonterra has decided that its Board of Directors will remain responsible for communicating directly with shareholders, therefore remaining active on their representative role, at least to a certain degree. Different Directors would be closer to management (governance) and some would be closer to shareholders (representing), hence depending on the Directors it is likely that Directors would spend between 20-30% of their time dedicated to meeting with shareholders through the channels that have already been analysed above.

In large co-operatives like Fonterra, voting for Directors can be seen by many farmers as the only way to manifest their thinking in the co-operative, but at the same, time how do they evaluate the performance of individual Directors when voting? The current election system in

Fonterra is based on the theory of having the best nine farmer-Directors from across New Zealand, irrespective of where they come from. Again, as a consequence the closeness of farmers and Directors gets affected. Due to the aforementioned problems, alternative voting systems (i.e. an electorate college system) have been suggested over recent months in the media.

Looking it from the governance point of view, Fonterra is a \$13 billion multinational company doing business worldwide involved in complex FMSM and business relationships, the company needs expertise in those areas that are not necessarily in farmer-Directors' backgrounds. Fonterra has dealt with that necessity by increasing the number of appointed Directors from three to four. Theoretically the company can increase that number again, but there is a limit if the company wants to remain farmer-controlled.

As it is impossible for shareholders to assess the performance of individual Directors at the governance level and their only real possibility of evaluating them is at the Directors/farmers meetings (representative level), the company runs the risks of having efficient politicians rather than efficient Directors at the Boardroom. In March 2002 appointed-Director Mike Smith resigned from the company due to what he called 'governance problems' in the Boardroom, although the details of those governance problems were never clarified.

There is probably no right answer to the governing/representing conflict Fonterra and all major co-operative Directors face. In the case of Fonterra the solution, at least to some degree, lies in complementing the Board with the Council for fulfilling the governing and representing roles: *"I believe that a Council can truly add value because they can represent the aspirations and goals of the co-operative if they are doing their job well, and Directors need to be at a level above that, they have got to be aware of that, but they don't want to be down on the swamp of that because they have got this international business to direct"* (John Wilson, former Chairman of the Shareholders' Council, personal interview, August 2002). So far, these two bodies have been operating independently, learning their respective position in the new structure; the challenge for them now is to proactively operate rather than concentrate on the lead-dog and watchdog roles.

The other part of the solution lies in the formation of highly qualified Directors, something that Fonterra is aiming to achieve through its Industry Training and Development program.

(VIII) Conflicts associated with the chosen capital structure

As Jim Van der Poel, now a Director of Fonterra, stated in an article in the Dairy Exporter magazine in May 2002, the formation of Fonterra raises significant questions in terms of how Fonterra should fund its future capital requirements. The alternatives according to Van der Poel are three: capital should come from all shareholders equally, shareholders should be given ownership or investment options, or capital should come from external partners. Although he clearly indicates his preference for a model with different types of shares with outside partners providing capital only through JVs, he argues the debate is urgent.

The urgency of that debate comes from potential conflicts than can arise in the near future from a considerable international wealth growth (as expected) with the current capital structure. As the majority of the conflicts identified below are not immediate challenges, the company has some time to make the necessary changes to its capital structure. Project Galileo and the capital structure review should address most of these issues.

Fonterra's current capital structure, although advanced and sophisticated by world standards, does not address some extremely important issues related to the internationalisation strategy the company is following. One of these issues is whether farmer-shareholders should have the option to invest or not in the value-added side of the business as opposed to uniform investment along the value chain or if there should be different levels of commitment and shareholding; at the moment there is no choice. The advantages of the current capital structure, include the fair value assignation for new entrants and shareholders leaving the company, even distribution of risks and value among existing shareholders and having one uniform category of shareholders with no different groups and different interests inside the co-operative.

Under Fonterra's current capital structure the company has three alternatives sources of capital to invest in growing its international businesses. The first one would be to use capital

generated by the subsidiaries itself to grow (generic growth). The second source of capital could be retentions from shareholders profits. The risk of this alternative is that some farmers have very short timeframes, judging the performance of their co-operatives on an annual basis relative to the competition, making difficult and unpopular to retain profits. The third alternative would be to leverage the company's balance sheet, increasing borrowings, but also increasing financial risk.

From the strictly financial point of view, Fonterra has made the maximization of the milk price (payout) its first priority, with the maximisation of the returns on equity to its shareholders the second. In other words payout first, value creation second. Probably a good example of this was Fonterra's decision to stick with its earlier commitment to give its farmer-shareholders a record \$5.33/kgms payout even though sharply falling commodity prices impacted the company's result and \$50 million, or \$0.05 per kgms, from reserves had to be used. The decision surprised certain external observers who would have been expecting Fonterra to put money into reserves for further expansion purposes⁴⁰.

In the longer term, if Fonterra is successful in its internationalisation strategy, which is the obvious aim, and creates a considerable amount of value, it will face inevitable conflicts due to the current capital structure. If the company does not pass on the created value but instead uses it for further growth, in other words the company continues growing internationally but the milk payout does not increase, the total value of the company will be reflected on its shares (FVS) having the effect of discouraging new entrants. On the other hand if the created value is passed on through the dividend (value added component) in the milk payout, it creates signal distortion; either way the effects will be negative. It has to be reminded although, that such conflicts are not immediate for Fonterra, as in season 2001-2002 only about 16 cents out of \$5.30 payout corresponded to returns from its international value-added portfolio, although according to company estimates value-added return for the coming season will border the 70 cents mark, in other words a significant portion (19%) of the \$3.70 forecast payout. Still, as the company's CEO indicated⁴¹: Fonterra is, and probably will remain in the

⁴⁰ According to Lincoln University's Professor of Agribusiness and Farm Management, Keith Woodford, interviewed by Fencepost.com, 22 July 2002.

⁴¹ Craig Norgate, Fonterra CEO, Dexcel Ruakura Dairy Farmers' Conference, 15 May 2002.

immediate future a business strongly based on the commercialisation of New Zealand dairy commodities.

The two aforementioned possibilities are analysed below:

a) New entrants discouragement

If Fonterra is successful offshore, and especially if its offshore subsidiaries are extremely successful, creating a significant increase in value, this will be reflected in the company's FVS and the cost of the shares will eventually go up. In theory, if the increase in the FVS is not accompanied with a high milk payout it could have the effect of discouraging new entrants due to the high capital requirements, and to a certain extent, encourage existing farmers to leave the company (or retire early) due to the attractive financial reward, either way the company would be losing milk supply. On the other hand, if the FVS keeps in step with milk payout, in other words both increase, which is the most likely situation if the company's value-added enterprises experience considerable growth, there would not be such negative effect as farmers would be able to afford the FVS as they get the cash, although this could generate a different conflict (see signal distortion below).

It can be said that to a certain extent, this is a conflict Fonterra is already facing with a combined cost of shares and capital notes currently at \$4.85, which can already be considered discouraging with the forecast milk payout for year 2002-2003 at \$3.70. As it is likely that milk payout would remain around the \$4 mark in the near future, if the share value increases significantly (e.g. \$6 - \$7 per share), the conflict is possible to happen. Having said this, Total Shareholder Returns (TSR), the returns of the payout (above the CMP) plus the increase in the FVS, is the real indicator of profitability of the business, and therefore the signal farmer-shareholders should be looking at.

A substantial increase of FVS could also have negative implications over the share-milking system: *"There could be legal difficulties if a farm-owner tried to stop a sharemilker from increasing production just so the owner could escape having to buy additional shares"* (Jeff Bolstad, Federated Farmers National sharemilkers sub-section Chairman, stuff, 21 of August 2002). It is likely that as farmers get use to the capital structure and recognise FVS as

business assets rather than expenditures, this conflict will not happen; still liquidity will play a key role for farmers wanting to increase their production in a determined season.

b) Signal distortion

If Fonterra is extremely successful in its value-adding strategy, delivering gains to farmer-shareholders through the dividend (value added component), with the value added component becoming a considerable part of the total payout, the company would be delivering a distorted signal.

In a corporate-company raw product and dividend are de-linked. In Fonterra, and in most co-operatives, farmers get both signals mixed in the milk price or milk payout. Even though Fonterra separated its actual milk returns (AMR) and value added components, in reality farmers receive both through a single signal, milk payout, and that is the signal farmers follow in order to increase or decrease production, with the AMR component and the value added component being used more for performance evaluation purposes (benchmarking).

The risk of delivering distorted signals, paying dividends through the milk payout to farmers is two-fold: encouraging farmers to over produce milk and eventually undermining their competitiveness and ultimately the company's competitiveness.

In terms of the first one, if over time the dividend coming from the value-added part of the business becomes an important part of the payout, farmers could eventually produce above what the milk is worth (AMR) because what they get is a single signal telling them to produce. Secondly, as farmers would be encouraged to produce milk at an un-real price (above market price), they would do it even if they have to incur extra costs (i.e. feeding infrastructure) to produce that milk, therefore they would be abandoning their competitive low-cost of production advantage. The fact that farmers would have to fund the marginal FVS capital (for the marginal production) could mitigate, to an extent, this issue.

In this respect, the challenges for Fonterra are related to both its capital structure and its payment system. Although significant production increases are generally not immediate to implement, as they imply larger investments and implementation cycles, farmers can (to a limited extent) respond to short-term production signals (i.e. milk payout). A good example of this happened at the end of season 2001-2002 when the signal the company was giving to its supplier-shareholders was of \$5.33 per kgms (Forecast payout), while the market price was closer to the \$3 mark. This increase in late-season milk volumes was later identified by the company as one of the causes of the \$50 million loss declared on its Annual Report.

The company must find a way to differentiate its pricing in terms of volume, timing and special characteristics as much as possible, to better reflect the handling costs and market returns of each member's production specifically.

“One of the fundamental principles that underpin New Zealand farmers' ability to successfully produce milk at the world price is our ability to be efficient at producing high quality milk relevant to our main competitors. It is important as we go forward to continue to give farmers accurate signals as to the value of additional milk so that we always attract profitable milk to the co-operative. It has been my experience that farmers are very good at responding to signals and therefore it is important that they always receive the right signals so that we get the right responses” (Jim Van der Poel, Director of the Board, personal interview, July 2002).

(IX) Risks associated with collaborative business relationships (JVS and Alliances).

Bartlett and Ghoshal (2000) argue that, even though benefits generally outweigh the risks, there are several risks that must be acknowledged by companies entering into collaborative business relationships (i.e. JVs and alliances):

- The possibility that the collaborative venture may be asymmetrical, in other words that one of the partners would be more benefited than the other in the business venture.
- The possibility that one of the partners internationalise the other's skills while carefully protecting its own.

- The risks that the partner would utilise its newly acquired skills against the company in a geographic area outside of the venture's limits.
- The lost of the benefits for the company of 'learning by doing'

Fonterra has traditionally used JVs to enter and serve foreign markets; therefore it can be assumed that the establishment of JVs and its implications is something that the company dominates. The company although, is entering into a strategic alliance in the Americas with Nestlé, the world's biggest food company, and it must ensure that the aforementioned risks are constantly taken into consideration as the rules of the game are different and the potential gains as well as the risks are higher.

(X) Risks and conflicts associated with the internationalisation of knowledge and capabilities

Fonterra has so far only internationalised part of its capabilities, namely its off-farm capabilities (i.e. collecting, processing, production). The company faces an eventual conflict: if the company does not internationalise (leverage) its capabilities to the full extent, especially those that represent the core of its competitive advantage, it runs the risks of failing; on the other hand if the company does internationalise its capabilities to a full extent, including on-farm capabilities, it runs the risk of putting its farmer-shareholders in a disadvantaged situation.

If Fonterra decides to internationalise its capabilities to the full extent, including on-farm capabilities, it will be benefiting the businesses where the company is involved overseas and even creating some parallel business opportunities, for the benefits of its shareholders. In fact, business theory indicates that if a company does not leverage its 'core capabilities', the reason why the company succeeds over its competitors, the risks of failing overseas or just being one more player are enormous. Enderwick & Akoorie (1996) indicated that there are two conditions to internationalise capabilities: they should not be easily copied or imitated by local competitors, and they should be internationally transferable at low cost

Fonterra has demonstrated its competitiveness in the dairy industry by for example, attracting Nestlé and entering into a strategic alliance in the Americas. For that alliance to work, both partners must contribute equally both in terms of financial contributions⁴² and in terms of capabilities and knowledge contributions, although the extent of Fonterra's capabilities contribution in Dairy Partners Americas has not been fully clarified.

On the other hand if Fonterra eventually decides to internationalise its on-farm capabilities and for example teach dairy farmers offshore, suppliers of its offshore businesses, how to produce milk more efficiently, the company will face potential conflicts from its own farmer-shareholders in New Zealand, if they perceive it is putting them in a disadvantaged position.

“Milk quality improvements and those sort of things is something that we can internationalise. But the sharp end of what we are doing in New Zealand, we've got to try to keep the benefits for our channels, so there has to be a balance between the two” (Craig Norgate, CEO Fonterra, personal interview, August 2002).

Dairy farmers from certain competing countries, especially from the developing world (India, Latin America) are closely situated in their cost curve in comparison with New Zealand dairy farmers (see Appendix III) and its likely it could only take small improvements in breeding programs or grass management technology, to equal or surpass New Zealand's productivity. Also, it has to be considered that if the company decides not to internationalise this knowledge, which is not the exclusive property of Fonterra, it is likely that it will find its own way to these markets as it is already doing through for example New Zealand farm consultants working overseas. In other words if the company does not internationalise these capabilities and distribute uniformly the value through its shareholders, some few will take the benefits. So, there is an additional risk associated with the speed by which Fonterra can commercialise this knowledge. If the company is slower at commercialising that knowledge than other businesses, it can find both itself and its farmer-shareholders disadvantaged and it will have then to exclusively focus on the leveraging of its other capabilities to remain competitive offshore.

⁴² The valuation process of the existing operations of both companies in the region is already finished and both companies will be contributing similar amounts of capital.

Figure 8: Fonterra Knowledge and R&D Network

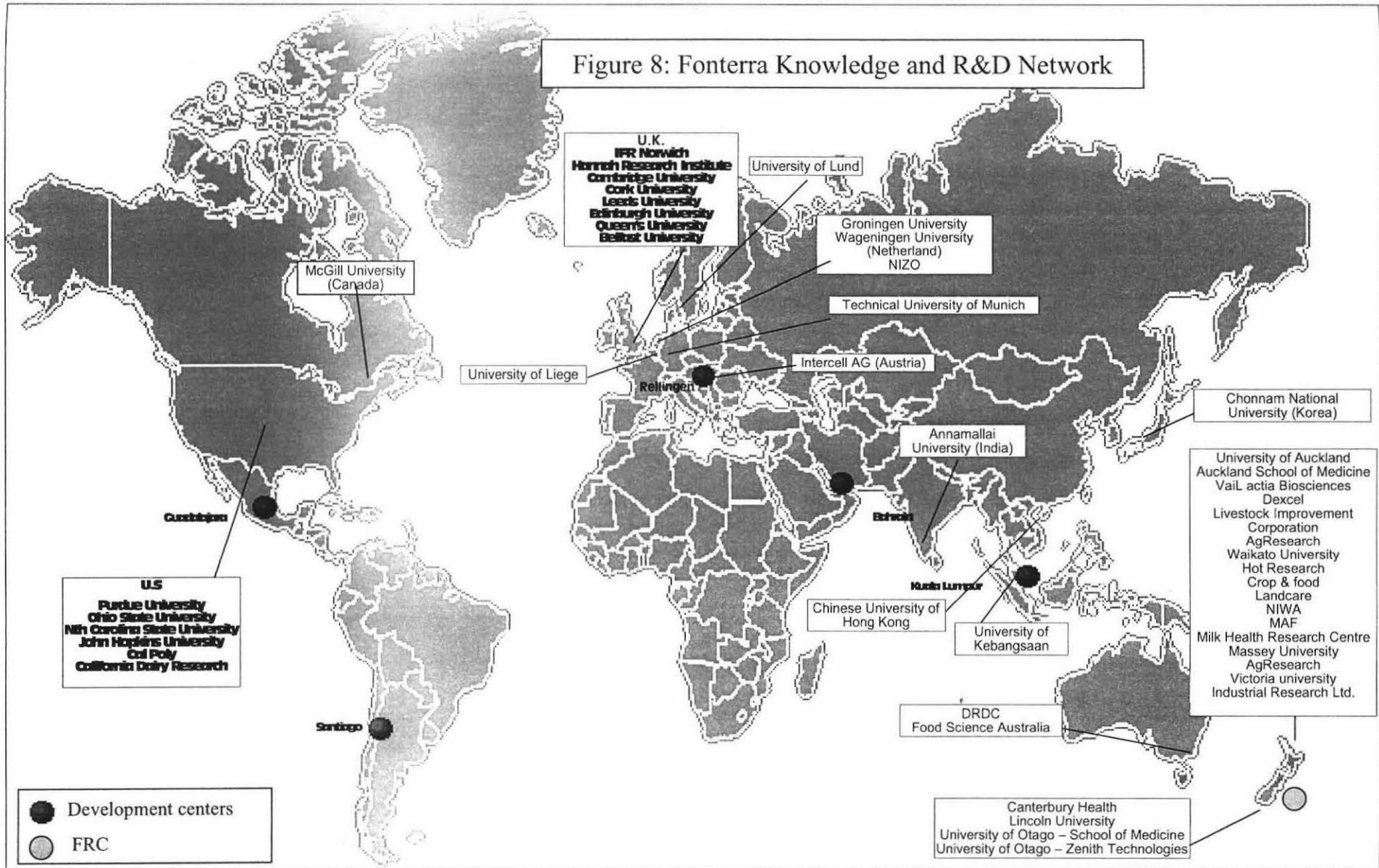
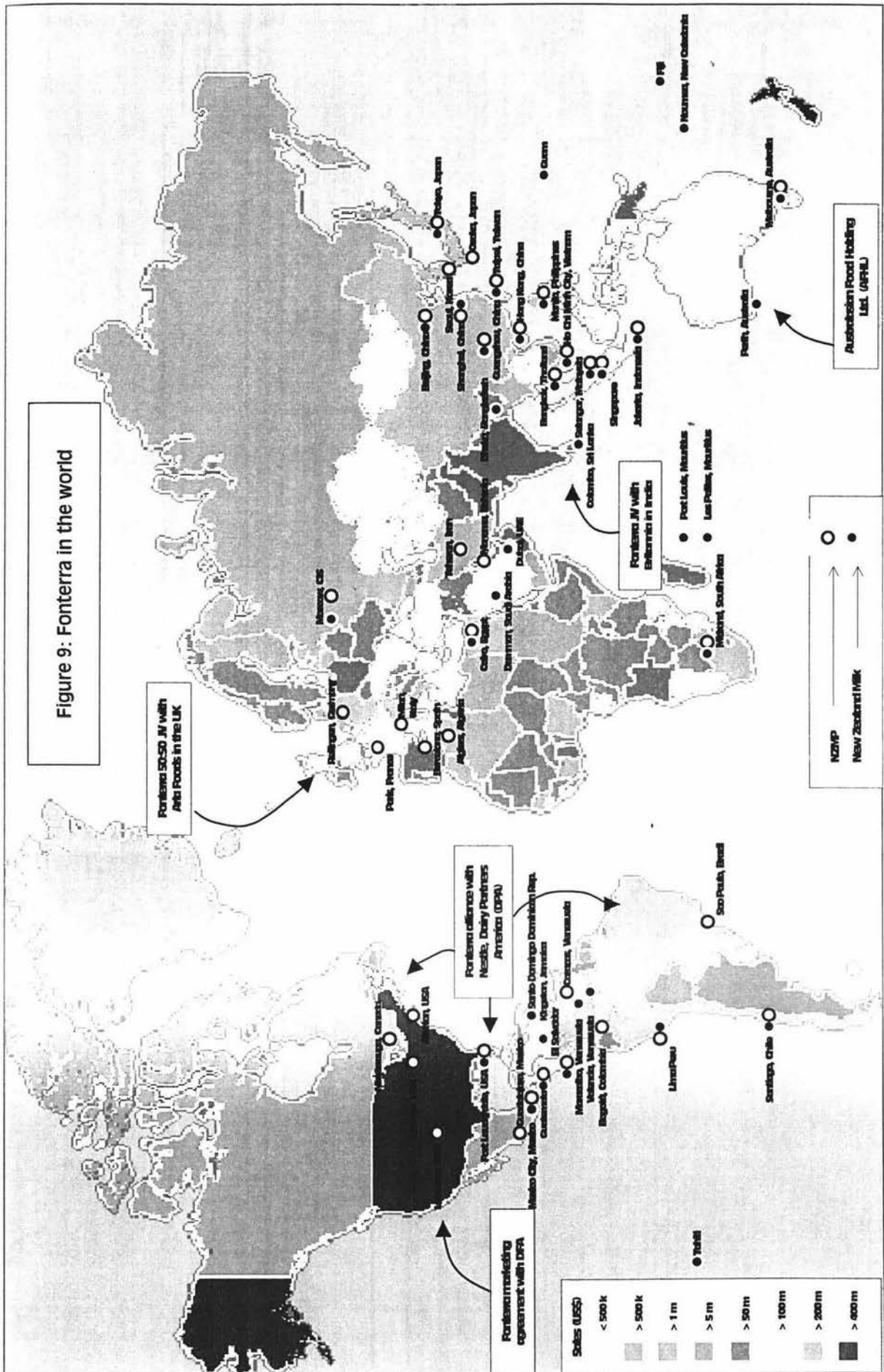


Figure 9: Fonterra in the world



CHAPTER FIVE: ZESPRI GROUP CASE STUDY

5.1 Company overview

Zespri Group Limited (Zespri) is the holding company of Zespri International, the world's largest marketer of kiwifruit, with annual revenues in the season 2001-2002 of NZ\$ 800 million generated from the sale of over 65 millions trays of kiwifruit. The group also includes Zespri Innovation Co. Ltd. and Aragorn Ltd. as subsidiaries. Zespri currently has a 25-30% year-round world market share of the kiwifruit category; the percentage goes up to 60-70% when considering only the Southern hemisphere supply season. Zespri is the statutory single-exporter of all New Zealand kiwifruit to all world markets except to Australia.

Although Zespri is listed in New Zealand under the Companies Act, Zespri is a grower-owned and grower-controlled organisation with a genuine co-operative voting system of votes tied to production levels and shares, set within an IOF/corporate structure. So, unlike a traditional co-operative where growers must have shares to supply, in Zespri, New Zealand kiwifruit growers can supply without shares, but those growers do not receive the share dividend. Therefore, for this study Zespri is considered as a co-operative hybrid.

The season 2001-2002 was extraordinary for Zespri, generating record revenues for the third consecutive season of NZ\$800.4 million, a record net profit after tax of NZ\$7.2 million and a dividend payment of seven cents per share, the first of its three years of history, for grower-shareholders.

Zespri competes on the international markets with global marketers such as Dole, Del Monte and Chiquita, but unlike its much bigger competitors, Zespri is a single-product company that can be defined as a virtual company with no fixed assets such as land, packing, post-harvest or storing facilities.

The company has made public its intention of becoming a billion dollar company in a relatively short period of time. Essential to its plan is its strategy of transforming itself from a

seasonal (7-8 months) marketer of New Zealand kiwifruit to a year-round marketer of world-sourced kiwifruit in order to be able to supply customers on a continuous basis.

The year-round supply strategy has two parts: the first one is the marketing of ZESPRI™ Green kiwifruit produced in different parts of the world under the Zespri brand; the second part is the licensing of the Zespri-owned ZESPRI™ Gold kiwifruit variety to selected producers around the world. The strategy though, is proving hard to implement due to difficulties in procuring sufficient volumes of quality offshore product and also because of the ZESPRI™ Gold variety licensing moving slower than predicted.

As the company is heading towards implementing its strategy of becoming a year-round marketer of kiwifruit, forecasting a fourth consecutive record season, both in terms of export revenues and suppliers payout, there are issues on the local side that demand solution, being perhaps the most important the grower-shareholders feeling of distancing from the company due among other things to the chosen supply structure. On the international side, the challenges lie in making the 12-month strategy succeed.

5.2 History⁴³

The kiwifruit industry in New Zealand is a young industry in global terms being about to celebrate 100 years of history, which began in 1905 when 'Chinese gooseberry' seeds were raised for the first time in New Zealand. Twenty years later, the Hayward variety, commonly called green kiwifruit, was developed by a New Zealand nurseryman (Hayward).

It was not until 1959 that the first exports of this new fruit were made, using the name 'kiwifruit' to identify the New Zealand source. By that time there were widespread planting of vines in the Bay of Plenty region

⁴³ Based in Zespri 1997 Annual Report, Enderwick & Akoorie (1996) and Yaf (1998).

The kiwifruit industry has had several representative organisations under different names since 1970 when the Kiwifruit Export Promotion Council (KEPC) was formed. The KEPC was the first formal grower-marketer co-operative structure for the kiwifruit industry. Later in 1977 the Kiwifruit Marketing Licensing (KMLA) was formed, adopting its predecessor as an advisory committee, changing its name in 1979 to the New Zealand Kiwifruit Authority (NZKA). The New Zealand kiwifruit industry was deregulated between 1977 and 1988, and in 1988 the New Zealand Kiwifruit Marketing Board (NZKMB), the statutory producer Board was established (Yaf, 1998).

Over the last 30 years the kiwifruit industry has been in an up-and-down cycle, with the 1980's seeing huge orchard investment, the 1990's watching the industry almost collapsing, and today in the 2000's the industry is looking healthy again with the price of orchards rising.

By 1993 the NZKMB's single exporter status was under threat following a disastrous 1992 season which saw returns falling to historic lows, causing an almost collapse, as not enough money was made to repay the bank loans. In the same year the United States imposed a 98% dumping tariff on all New Zealand kiwifruit in response to dumping allegations, which lasted for 8 years. 1993 also marked the beginning of a restructuring process, which started with the creation of Kiwifruit Grower Incorporated (KGI), followed by the development of the ZESPRI™ brand and eventually the transformation of Zespri into a grower-owned corporation.

In 1997 NZKMB's operations were separated between Kiwifruit New Zealand (KNZ), former NZKMB, and the marketing subsidiary Zespri International Limited. In 1998 collaborative marketing was implemented and onshore operations were deregulated. Finally, in 1999 through a referendum approved by 90% of the growers, Zespri became a grower-owned corporation, with Zespri Group Ltd. being the holding company, Zespri International the marketing company and Kiwifruit International being floated to provide venture capital.

The last chapter in Zespri's history that shaped its structure happened in November 2000 when growers Alan Sutherland⁴⁴ and Allan Dawson gained the support of 12.5% of shareholders to force a special general meeting due to concerns of an eventual takeover by corporate hands, which were partly raised by the recent ENZA⁴⁵ takeover. At that special general meeting 94.4% of the growers voting at the meeting (66% grower turnout) favoured introduction of the proposed voting system tied to production levels, establishing a co-operative-like control mechanism within a commercial company structure, giving Zespri its co-operative hybrid current structure.

5.3 Environment

5.3.1 World kiwifruit industry

On a global scale, the kiwifruit industry is relatively small among major fruits, with global consumption of kiwifruit accounting for approximately 1% of total fresh fruit consumption (Enderwick & Akoorie, 1996).

As it can be seen on Table 16, all major fruits have experienced a significant increase in their production levels over the last 20 years. For the world (excluding China) per capita availability of kiwifruit has been relatively flat since 1992 at about 200 grams per person. This means that kiwifruit is one of the few fruits where production has not been growing faster than population growth. When China is taken into account the image changes drastically. In fact, China's kiwifruit planted acreage has increased from 35,000 to 50,000 hectares over the last five years (Belrose, 2002).

Although levels of fresh fruit consumption in Western countries is below the levels recommended by health organisations, fruit consumption is reported to be reaching saturation

⁴⁴ Allan Sutherland would be elected as a Director on Zespri's Board.

⁴⁵ ENZA is the former Apple and Pear Marketing Board, which was acquired by corporate investors.

point. In addition, fruit production over the last decade has increased at almost twice the rate of population growth, resulting in significant overproduction. The situation is believed to be worst in the products in which the large fruit traders are extremely dependant, namely the banana and the apple markets (Rabobank, 2001b).

Table 16: World production of major fruits.

Fruit category	Production 1989-1991 (1000 metric tonnes)	Production 1999-2001 (1000 metric tonnes)	Change (%) 89-91 to 99-01
Apples	34,362	59,894	+ 74.3
Grapes	66,106	63,227	- 4.4
Oranges	38,751	65,961	+ 70.2
Bananas	38,162	65,587	+ 71.9
Berries	2,478	5,007	+ 101.3
Kiwifruit	718	1,193	+ 66.2
Total fruits	276,381	441,316	+ 59.7

Source: Belrose (2002)

The situation in the kiwifruit industry is apparently slightly better and there is reason for modest optimism according to the World Kiwifruit Review 2002 (Belrose, 2002), but gains for kiwifruit will have to come at the expense of other fruits already on market shelves.

Kiwifruit production is clustered between the 38° and 42° latitude North and South. Major producing countries are Italy (33%), New Zealand (24%), Chile (12%) and France (9%), which in turn are also the major exporters (Table 17). China⁴⁶ is also a considerable kiwifruit producer although figures are difficult to obtain and all production is consumed locally.

⁴⁶ China, unlike the rest of the world, has two kiwifruit industries: commercial plantings and fruit harvested from the wild.

Table 17: Kiwifruit production, exports and imports of selected countries

(Figures in metric tonnes, 1999-2002)

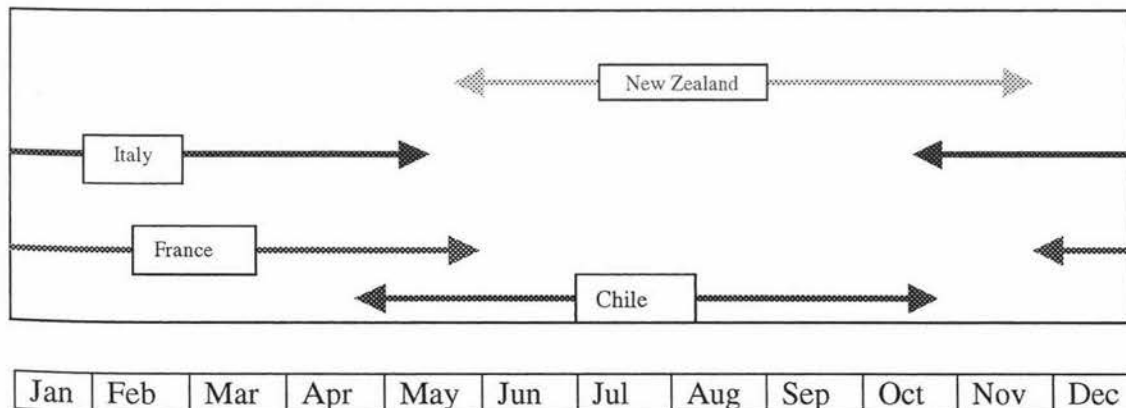
Country	Production	Exports	Imports
Italy	337,000	265,000	29,667
New Zealand	236,316	219,774	150
Chile	150,000	108,500	0
France	73,067	28,190	29,054
Japan	36,700	0	43,000
US	26,006	5,305	51,987
Spain	13,933	10,033	82,200
Australia	5,000	1,133	16,167

Source: Belrose (2002)

In general terms Northern and Southern hemisphere productions are complementary; however, improved storage technology and production practices have caused seasons to increasingly overlap and to eliminate end-of-season premiums or exclusive selling windows (See Figure 11). In the Southern hemisphere supply season, where Zespri currently operates, the market is two-thirds dominated by Zespri, with the remaining third belonging to traders exporting from Chile.

Although two out of the three biggest producing countries of kiwifruit are located in the Southern hemisphere (i.e. New Zealand and Chile) the vast majority of kiwifruit is consumed in the Northern hemisphere, specifically in Europe, South East Asia and North America.

Figure 11: Kiwifruit supply season of selected countries.



(Source: Based on Zespri Workbook, 2001)

5.3.2 Main competitors

Besides the already discussed stagnant consumption and the production oversupply, the consolidation of the retail industry, globalisation of chains, growth of private (store or own) labels and the emergence of buying alliances are some of the key trends in the grocery and retail industries that have been putting under increasing pressures fruit trading companies during the last couple of years and has resulted in year-after-year decrease in the results of major fruit traders (Rabobank 2001b).

When trading on the international markets, Zespri competes with multinational multi-product companies like Dole, Del Monte Fresh Produce, Chiquita and Fyffes. The current fresh fruit trade industry has been described by Rabobank (2001b) as really fragmented, having thousands of traders. As a result, the top four listed companies have an estimated combined share of the wholesale value of world fruits of only 6%. If the calculation is done related to world exports of fresh fruit the figure rises significantly to 35% (Table 18).

Table 18: Market shares and net revenues of the top four listed fruit traders

	Net revenues Year 2001* (US\$ billions)	Whole sale value of world fruits market share (%)	World export market share (%)
Dole Foods	4.29	2.5	14.7
Fresh Del Monte	1.96	1.2	7.9
Chiquita Brands	2.33	1.1	6.7
Fyffes Plc.	1.57	1.0	6.0
Total	10.15	6	35

Source: Adapted from Rabobank, 2001b)

Key: * = 2001 annual sales including fresh and processed products

These much bigger competitors, for whom kiwifruit is one product within a wide range of product lines, have been passing through tough years that have originated several restructuring processes. Chiquita for example has more than 150 branded products, from fresh fruits including kiwifruit sourced largely from Chile, to juices and processed and packaged goods. Dole, the world's largest producer and marketer of fresh fruit and vegetables, has more than 215 product lines, including kiwifruit, again often sourced from Chile. Finally Del

Monte, which has undergone a serious of ownership changes, being currently controlled by the Saudi Arabian family Abu-Ghazaleh, has over 50 product lines.

Rabobank identified 'commoditisation' as one of the main causes for the industry's current situation; *"An underlying problem that has been bothering the sector for decades and compounding the current problems is fruit seen as a commodity, which has given the sector a rather dull image. In addition, there is a lack of buyer loyalty in the fruit sector there are few distinct consumer brands and therefore buyers shift easily from one product to the other. So the primary key success factor deals with perception, from commodity to value added product"* (Rabobank 2001b, p.4).

Kiwifruit has not been the exception to the rule, with world prices declining over the past years for most fruit traders. Zespri, by focusing 100% on kiwifruit and with strong branding and promoting strategy has been able to somehow remain outside the commodity cycle and obtain higher prices than its competitors (Belrose, 2002).

5.3.3 New Zealand kiwifruit industry situation

"The origins of the world kiwifruit industry lie firmly within New Zealand. New Zealand can take credit for the development of the commercially successful Hayward variety, for introducing and driving demand for the fruit in the world markets, for setting quality standards for the world to follow, and above all for creating and promoting the name 'kiwifruit' worldwide" (Enderwick & Akoorie, 1996, p.261).

There are approximately 11,500 hectares of kiwifruit in New Zealand of which 10,100 are productive. Hayward, the predominant variety accounts for 89% of the productive area and ZESPRITM Gold kiwifruit accounts for the remaining 11%. If considering a total exported volume in 2001-2002 of 65.9 million trays, it gives an average orchard productivity of 6520 trays of kiwifruit per hectare.

The importance of kiwifruit in New Zealand's horticultural industry is quite significant, with exports of kiwifruit accounting for a third of all horticultural exports, followed by apples and

pears with about 24% (Table 19). It is interesting to note how the industry developed from non-existing to the current situation in just 35 years.

Table 19: New Zealand horticultural exports (NZ\$ million, FOB).

	1965	1975	1985	1995	2000
Apples	5.0	19.3	108.2	482.1	404.5
Kiwifruit	-	2.9	171.9	320.8	462.0
Other fresh fruit	0.6	0.8	28.4	66.0	96.1
Total fresh fruit	5.6	23.0	308.5	868.9	962.6
Total horticultural exports	8.2	33.5	481.2	1,416.8	1,693.2

Source: HortResearch, (2000)
 Note: Figures adjusted for year 2000 NZ\$.

The New Zealand kiwifruit industry is made up of three main entities: Kiwifruit New Zealand (KNZ), which has a regulatory monitoring role; New Zealand Kiwifruit Growers incorporated (KGI), which is the national organisation representing New Zealand kiwifruit growers; and Zespri Group Limited, holding company of Zespri International, the marketing and exporting company with monopoly powers for all New Zealand kiwifruit exports except those going to the Australian market.

In general terms it can be said that Kiwifruit New Zealand (KNZ) has two distinct roles: act as the kiwifruit industry’s regulator and Zespri’s ‘watchdog’, and be the organisation that approves collaborative marketing applications. Collaborative Marketing programs are the exception to Zespri’s single-exporter status, where companies that find new markets and new product formats, which are not being currently explored by Zespri, can export if it is proved that the activity will add value and will not compete with Zespri. Collaborative Marketing programmes are coordinated between KNZ, ZGL and the collaborative marketers.

KGI in turn, was formed to give growers their own organisation with its ‘voice’ that would develop a secure and stable kiwifruit industry for the benefit of all growers. KGI is made up of 38 district representatives with an additional four co-opted members from special interest groups; together they form the KGI Forum.

Although the New Zealand kiwifruit industry is regulated in its exports, with Zespri having the sole-exporter status, it is deregulated on-shore, with competition happening among packhouses, cool-store operators and fruit suppliers for attracting growers' preferences. The post-harvest sector consists of packhouses, cool-stores and suppliers. Of special importance are Fruit Supply entities ('suppliers') as they interact with Zespri in all operational and financial issues. Some of the suppliers are integrated entities (packhouse-coolstore-supplier) and some are not; also among the suppliers, of which there are currently twelve, there are entities of co-operative type structure and of corporate/IOF structure.

The New Zealand kiwifruit industry has followed a consolidation trend that has seen a decrease in the number of packhouses from about 520 packhouses in 1989 to just over 100 in 2002; there are also about 100 coolstore operations in New Zealand. Due to consolidation, major players have appeared on the post-harvest level; in December 2001 kiwifruit co-operatives Baypack and Katipack merged to form the industry's biggest supply entity, Satara Co-operative Group, with an output of 10.4 million trays (1/6 of New Zealand production). Also at the end of 2001, another big player, Seeka Kiwifruit Industries, purchased Waimapu Group, meaning that the company controls another sixth part of the New Zealand crop.

5.3.3.1 Eventual deregulation

Although there are different views about the certainty or not of the New Zealand kiwifruit being deregulated and the views obviously change depending on where the comments come from, the discussion has never been closed and it might come back again in the future considering that Zespri is the only sizeable co-operative type structure with a monopoly export privilege that still exists in New Zealand after the dairy and apple industries were deregulated in 2001, therefore the importance of analysing an eventual deregulation and the impact it would have over Zespri is obvious.

The former head of New Zealand's Apple and Pear Marketing Board, Joe Pope, told the New Zealand Herald in September 2002 he believes the kiwifruit industry will be deregulated within three years: *"It is the last export monopoly in New Zealand; when we had the NZ*

*Dairy Board there, the small industries were safe, but the Dairy Board has voluntarily changed (into Fonterra) and Zespri is ready to change*⁴⁷.

Pressures for deregulation have come towards Zespri from several fronts including other sectors in New Zealand, foreign kiwifruit buyers, minority grower groups⁴⁸ and even eventually to a limited extent from Zespri's grower base, as a consequence of tensions among product-groups due to the current pool equity and supply structure.

Zespri's position on the subject is quite clear, the company recognises the single-channel as one of its core advantages and therefore of New Zealand kiwifruit growers in world markets. On that basis, it strongly defends the single desk and there is confidence within the organisation that if they continue performing, the status quo will remain and it might be accurate to state that after three consecutive years and a forecasted fourth year of record revenues the company stands on much more ground in terms of growers' support, for the current structure to remain.

Even if the industry is deregulated, Zespri should stay with the major percentage of the market, as was the case with former statutory bodies/companies such as Capespan in South Africa or even Enza in the deregulated New Zealand apple industry. Considering the massive head-start Zespri would have on any of its competitors in terms of marketing contacts, marketing systems, its ZESPRITM Gold variety and its R&D capabilities, it would be possible to forecast that Zespri would stay with a much larger stake of the local market than was the case with the apple and pear industry. On the other hand, if deregulation happens, it is quite possible that some of the strong suppliers currently in the New Zealand industry would jump from being logistics service providers to become fully integrated exporters.

Even within Zespri's lines, deregulation is considered an issue that Zespri will have to eventually face: *"It is important that the negatives of the single desk system do not come to the fore. The best way to do that is to prepare the Zespri culture for deregulation whether it is*

⁴⁷ The New Zealand Herald, 9th September 2002.

⁴⁸ In August 2002 The Independent published an article stating that a group of Maori kiwifruit growers producing about 5% of the yearly crop was lobbying politicians and foreign buyers for freedom from Zespri's statutory export monopoly.

likely to happen or not” (Alan Sutherland, Zespri Director of the Board, The Orchardist, September 2001, p.46).

If the New Zealand kiwifruit industry deregulates the change will have to come either from within the kiwifruit growers themselves or potentially from Government pressures. In terms of the implications of deregulation, although it is not the purpose of this study to evaluate the impacts of deregulation over the New Zealand kiwifruit industry as a whole, it is a fact that Zespri would be losing a strong competitive advantage and the company would have to base itself on its other core capabilities.

5.4 Current situation

5.4.1 Mission statement and strategy

As stated in its 2002 Annual Report, the company aims to fulfil its intentions of being the preferred international marketer of kiwifruit while maximizing returns to growers, suppliers and shareholders based on several strategies: *“Zespri’s aim is to be the preferred international marketer of kiwifruit with the underpinning business objective of ensuring sustainable shareholder wealth and optimising grower and supplier returns”* (Company statement, Zespri Workbook 2001, p.31).

One of the main strategies in place is competing on the international marketplace on value rather than price; for that purpose Zespri has a branding strategy, where it has developed a family of brands, with the ZESPRI™ brand being its flagship for top quality fruit and with the alternative K1W1™ brand for class 2 kiwifruit to be used in price sensitive markets around the world such as Portugal, Mexico, Australia, etc. Considering the different brands and products that Zespri markets it still has a very limited portfolio which includes: ZESPRI™

Green, ZESPRI™ Green Organic, ZESPRI™ Gold, ZESPRI™ Gold Organic, K1W1™ Green, K1W1™ Green Organic, K1W1™ Gold, and K1W1™ Gold Organic.

The other face of Zespri's branding strategy is that Zespri spends over \$40 million on promotion per year (5 % of its revenues), which is considered high for fruit trading companies, in order to try to differentiate its product from the commodity category. Originally the ZESPRI™ brand was only intended for New Zealand sourced kiwifruit, but now that the company is heading towards becoming a year-round marketer it is being used for externally sourced kiwifruit from different parts of the world.

Another aspect to consider is that as Zespri is a net buyer of foreign currencies, it has in place a currency hedging strategy through forward foreign exchange contracts. Zespri foreign exchange policy has the objective of protecting growers' returns from excessive volatility in the NZ\$ exchange rate, acting as an averaging mechanism that limits the highs and softens the lows.

Although currently Zespri is a 100% kiwifruit-focused company, and this can be considered a core capability or competitive advantage, the possibility of marketing other products has been mentioned on several occasions, but so far the company has not taken any steps into that direction.

"Occasionally customers ask me how can you survive being a one product company? On one side it can of course be a disadvantage, but on the other side it brings a wonderful clarity of focus when you live or die on your success with that one product" (Peter Luxton, Global Marketing Services Manager, personal interview, July 2002).

Although Zespri could eventually get involved in the sourcing and marketing of other fruits with similar characteristics to kiwifruit and by that way take advantage of some of its core capabilities, right now all the energy, focus and limited resources are spent on making of Zespri a year round marketer of kiwifruit.

The company has manifested its aim of increasing its business incrementally, in three or four years aiming for sales of 80 million trays of New Zealand-grown kiwifruit, up from 63 million in 2001, and 10 million trays of kiwifruit externally sourced either from Italy, US, France or Japan in its 12-month marketing program⁴⁹. That is equivalent to an increase of 26% of New Zealand product and would imply sourcing externally 11% of the total volume, up from practically zero.

5.4.1.1 The strategy of becoming a year-round marketer of kiwifruit

A key part of Zespri's strategy and one of specific importance for this study is the company's intention of transforming itself into a year-round marketer of fruit, "*The strategy to take the Zespri business from a seasonal marketer of NZ kiwifruit to a 12-month procurer and marketer of world sourced product is on track*" (Company statement, Kiwiflier, September 2000, p.5).

Until recently Zespri has restricted itself to being an 8-months kiwifruit marketer. Now, the company is moving to source and market kiwifruit for 12 months a year. The reasons for this movement can be found in both the pressures of international supermarket chains to be sourced on a year-round basis with the possibility of becoming category managers, as well as on the advantages of leveraging Zespri capabilities and utilising Zespri's infrastructure the whole year rather than just two thirds of the year.

The strategy has important implications for Zespri's New Zealand grower-shareholders, but in general terms the strategy is based on complementing the New Zealand seasonal production (6-8 months) with product from counter-seasonal production countries, in order to have the necessary 12-months supply base. Other branded produce marketers of co-operative type

⁴⁹ Based on Tony Marks's interview, Orchardist Magazine, July 2001, p.4.

structure that have followed the same strategy include citrus marketers Sunkist, and avocado marketers Calavo, both North American⁵⁰.

The 12-month marketing strategy is based on two main components; one is the external sourcing of ZESPRI™ Green kiwifruit and the second one is the licensing to third parties of the Zespri-owned ZESPRI™ Gold kiwifruit variety to be marketed exclusively by Zespri. For that purpose, the company has been actively entering into contractual agreements with producers especially from Italy and the US, but also from other countries. The strategy, although, has proved more difficult to implement than in theory.

5.4.2 Business structure

“Although our culture is based on co-operative principles, Zespri Group Ltd. is a company and as such we have an accountability to deliver short term profitability” (Doug Voss, Chairman of the Board, Zespri, Hortnews, June 2002).

Although Zespri Group Limited is not listed under the co-operatives act, but under the New Zealand Company's act, it will be considered in this study as a co-operative hybrid. Currently Zespri is a company where only growers-suppliers can have shares and even though shares are tradable, votes are tied to production levels, so shareholders can only vote in accordance to the number of shares they held and the quantity of fruit they produce, representing a genuine co-operative voting structure. The other uniqueness about the current structure is that unlike in a co-operative where growers must have shares to supply, in Zespri, New Zealand kiwifruit growers can supply without shares, which is a non-co-operative supply/ownership scheme. The reasons for this very unique hybrid structure can be found in the way things evolved over the last two years.

⁵⁰ Sunkist started sourcing Chilean lemons in 2002 and has indicated that it will eventually start marketing Spanish clementines to complement its Californian based production.

According to the company, when Zespri was restructured in 2000, the original intention was to have a co-operative structure but the outcome of negotiations held with the government was that if Zespri wanted to retain the single-exporter status it could not have a co-operative structure, therefore Zespri was corporatised and initially shares were issued to growers in proportion to historic production/supply levels. As shares are tradable, a percentage of growers sold their shares or converted them to cash when issued.

Then at the end of 2001, following concerns from grower-suppliers of losing control of the company, the voting structure was changed, giving Zespri its current hybrid nature. The company has been learning over the past two years the implications of this hybrid nature. Growers have also been learning the difference between being a supplier and being a shareholder and their respective measurements of fruit payout and share dividend payout.

Zespri as a company operates from a commission charged to all New Zealand suppliers, which has two components: 9% of net sales value plus a 3.6% of fruit returns, which together give an estimated 11.4% (as both margins are not additive). Out of that margin, the company subtracts its costs, including overseas offices and agencies costs, R&D and product development costs. Finally out of the profit the company's governors decide what percentage will be retained earnings and what percentage will be paid out as dividend. In September 2002 Zespri paid its first dividend (7 cents per share) of its short history.

5.4.3 Statistics and key figures

Zespri Group Ltd. is owned and controlled by about 2,500 growers and it can be said that in global terms it is a small company, having only 184 employees of which 115 are based in New Zealand and 69 are based offshore. The company has total assets with a value of \$77 million, liabilities of \$55 million, therefore equity of \$22 million. The company's equity has grown from \$4.3 million in year 2000, to \$7.6 million in 2001, to the actual levels of \$22 million representing a considerable increase, although still limited if the company eventually considers financing offshore growth plans.

Revenues have been steadily increasing for the company in the last years (Table 20) from \$650 million in year 2000 to \$800 million in season 2001-2002, representing a nominal increase of almost 25%. Average return per tray have also been increasing being \$7.23 last season, up from the \$6.87 for season 2000-2001, but below the \$7.62 of season 1999-2000. Forecasts for 2002-2003 indicate a fourth consecutive year with revenues increasing 10% and prices 11% above previous season.

In terms of revenues, Europe is Zespri's most important region and Japan its most important single market. Not considering Asia and Europe, sales from the rest of the world represent only 9% of total revenues. Collaborative marketing represented 15% of total revenues (Table 20).

Table 20: Zespri Group revenues by source/region and season

	2001/2002	2000/2001	1999/2000
Net Revenues (NZ\$ m)			
Europe	421.2	384.0	352.9
Japan	217.8	245.8	191.3
Asia	70.6	45.8	49.6
Rest of world	72.5	63.3	52.6
Collaborative marketing	12.6	6.6	4.2
Offshore trading	5.7	0.8	0.1
Total net revenues	800.4	746.3	650.7

Source: Zespri Annual Report (2002)

Table 21: Zespri revenues by product (season 2001-2002)

Returns per product	
ZESPRI™ Green (millions of trays)	54.7
ZESPRI™ Green (\$ million)	635.5
ZESPRI™ Gold (millions of trays)	5.2
ZESPRI™ Gold (\$ million)	94.7
ZESPRI™ Organic (millions of trays)	2.5
ZESPRI™ Organic (\$ million)	33.0
K1W1™/class II (millions of trays)	3.5
K1W1™/class II (\$ million)	26.0
Total volume (millions of trays)	65.9
Total revenues (\$ million)	789.3

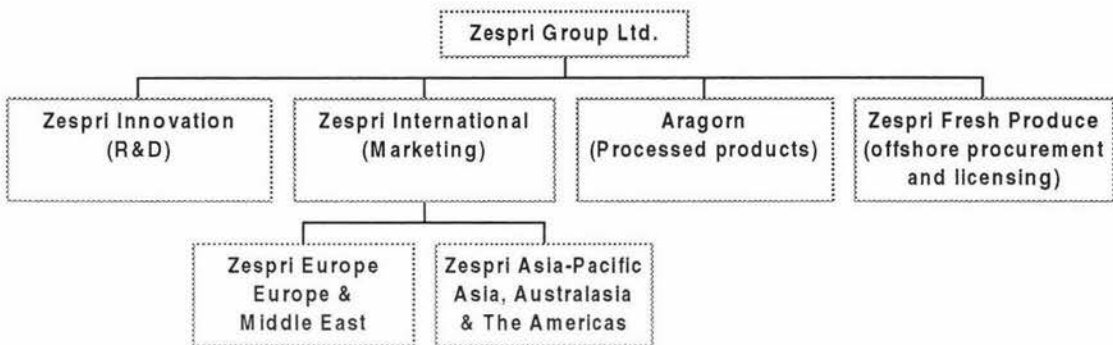
Source: Zespri Annual Report (2002)

5.4.4 Organisational structure

Zespri Group limited is the holding company of Zespri International, its marketing-core company; Zespri Innovation, its R&D company; and the recently created Aragorn, its processed kiwifruit company (see Figure 12). Zespri Group Limited has its headquarters in Mount Maunganui, New Zealand.

Zespri’s three main business units are wholly-owned subsidiaries: *“Our philosophy is that if there is an area of business that is specialised and needs a focus, let’s give it a business structure. Provided they meet all criteria, we will no doubt establish other companies in the same manner”* (Doug Voss, Zespri Chairman, Kiwifruit Journal, July 2002, p.9).

Figure 12: Zespri Group organisational structure.



Zespri International is the Group’s core company and shares the same Board of Directors with Zespri Group. Zespri International itself has a number of subsidiaries, but the world is essentially divided into two marketing arms, one of them is Zespri Europe, with its headquarters in Belgium and subsidiary companies in France, Spain, Italy and the UK. The other arm is Zespri Asia-Pacific, which is based in Japan and includes Asia, the Americas, the Pacific area and Australasia, with subsidiary offices in Korea, Taiwan and with an equity interest (15%) in a North American fruit trading company, David Oppenheimer & Co., which imports and distributes kiwifruit into North America.

Zespri Innovation is Zespri's R&D business, which works with all entities of the Group and was established to address the gap between external research providers and research users within Zespri. Also based in Mount Maunganui, Zespri Innovation is structured around four main research areas: fruit quality, environmentally sustainable crop protection, logistics and value added, and new cultivars.

The recently created Aragorn Ltd. is a commercial subsidiary concentrating on processed kiwifruit and related products. Although the company is only establishing itself and the way it will operate is not totally clear, Aragorn has been established as the exclusive avenue for all ZESPRI™ Gold kiwifruit that Zespri does not commit to fresh fruit sales. It will also process ZESPRI™ Green Organic and high sugar content kiwifruit.

Zespri Fresh Produce is the business unit responsible for the offshore procurement (or external sourcing) and production of ZESPRI™ Green Kiwifruit as well as the licensing of ZESPRI™ Gold kiwifruit to offshore growers, therefore representing a key business unit for Zespri's internationalisation. Zespri Fresh Produce is also in charge of developing and managing strategic collaborative marketing opportunities and international relationships and partnerships. Although very new, this business unit will grow as volumes and revenue numbers do.

Finally, Kiwifruit International Ltd. is a separate company, which is not part of Zespri Group Ltd., but acts as underwriter of Zespri's overseas activities. There is no connection between Zespri and Kiwifruit International other than having some common shareholders and having an agreement with Zespri Group to underwrite the non-New Zealand activities of the group. Kiwifruit International was set up because of existing legislation that demanded isolating New Zealand growers from offshore risks. In its role of underwriter Kiwifruit International had recently to write Zespri a cheque for \$136,000 because of losses incurred when trading Italian kiwifruit in the season 2001-2002.

Most of Kiwifruit International's shareholders (with a total equity capital of \$5 million) are New Zealand growers, although the company is open to foreign capital coming from international shareholders.

5.4.5 Governance structure (overview)

Zespri governance structure is very flat, having only two levels, the Governors of the business, made up of Executive Management and Board of Directors, and the grower-shareholders (Figure 13). Although there is a representative body, Kiwifruit Growers Incorporated (KGI), this is totally independent from the company and has no legal powers, even though it is recognised by the company as a valid interface between growers and governors.

As in most modern co-operatives and co-operative hybrids, the Executive Management team is totally external to the co-operative with no grower-shareholders among it. In Zespri, the only exception to this rule is in the Executive Chairman role, which was temporarily created to alleviate the CEO from some of New Zealand-based responsibilities in order to concentrate on the global marketing side of the business. By December 2002 the current Executive Chairman, Doug Voss, will step down becoming a non-executive Director and the Executive Chairman position will no longer exist, with the new Chairman of the Board leaving all Executive duties to the incoming CEO.

The Executive Management team, headed by the CEO, is responsible for the day-to-day management of Zespri Group. The company is governed from its headquarters in Mount Maunganui, where over 85% of the national kiwifruit is located, after being relocated from Auckland at the beginning of 2002.

As September 2002 Zespri's key senior executives were:

- Executive Chairman: Doug Voss

- Chief Executive Officer (CEO): Tony Marks⁵¹
- Chief Financial Officer (CFO): Janie Elrick
- General Manager Zespri Europe: Guus van der Kleij
- General Manager Zespri Asia & America: Yu-Jan Chen
- General Manager Zespri Innovation: Nigel Banks
- General Counsel and Company Secretary: David Lazarus
- Executive Chairman Aragorn Limited: Peter Stanes
- Industry Relations Manager: Todd Muller
- Global Marketing Service Manager: Peter Luxton
- General Manager Global Operations: Richard Punter
- Chief Information Officer: Grahame Coles
- Human Resources Manager: Lain Jager

The Board of Directors of Zespri is made up of eight members, six grower-elected Directors (also known as industry Directors) and two appointed Directors. The Board is responsible for the governing and policy direction of Zespri Group, including long-term strategy, strategic initiatives, budgets and policy framework as well as overseeing the executive team. The Board in turn has three operating committees: the organisation and administration committee; the audit and risk management committee, and the supply committee.

Three Directors have to resign each year and their positions be filled at the Annual General Meeting, with the possibility of being re-elected. Grower-shareholders elect Directors, being entitled to one vote per share, backed by kiwifruit production (10 trays per share).

Another unique characteristic of Zespri's governance structure is that appointed Directors also have to stand for re-election every three years. So even though the Board can initially appoint an independent Director without consulting growers, they have to stand for re-election and be confirmed (or not) by grower-shareholders at the next AGM.

⁵¹ By December 2002 Tony Marks will leave the company and a new CEO will be appointed.

As many co-operatives have been finding over the recent years, by having a mix of elected and appointed Directors the Board is in a better position in terms of its mix of skills and knowledge. So for example, in Zespri, expertise in areas like international marketing, company governance and business structures as well as backgrounds from other industries⁵² are likely to be brought-in by external Directors. At the same time by having a majority of grower-shareholders as Directors of the Board, the control of the company by growers is ensured.

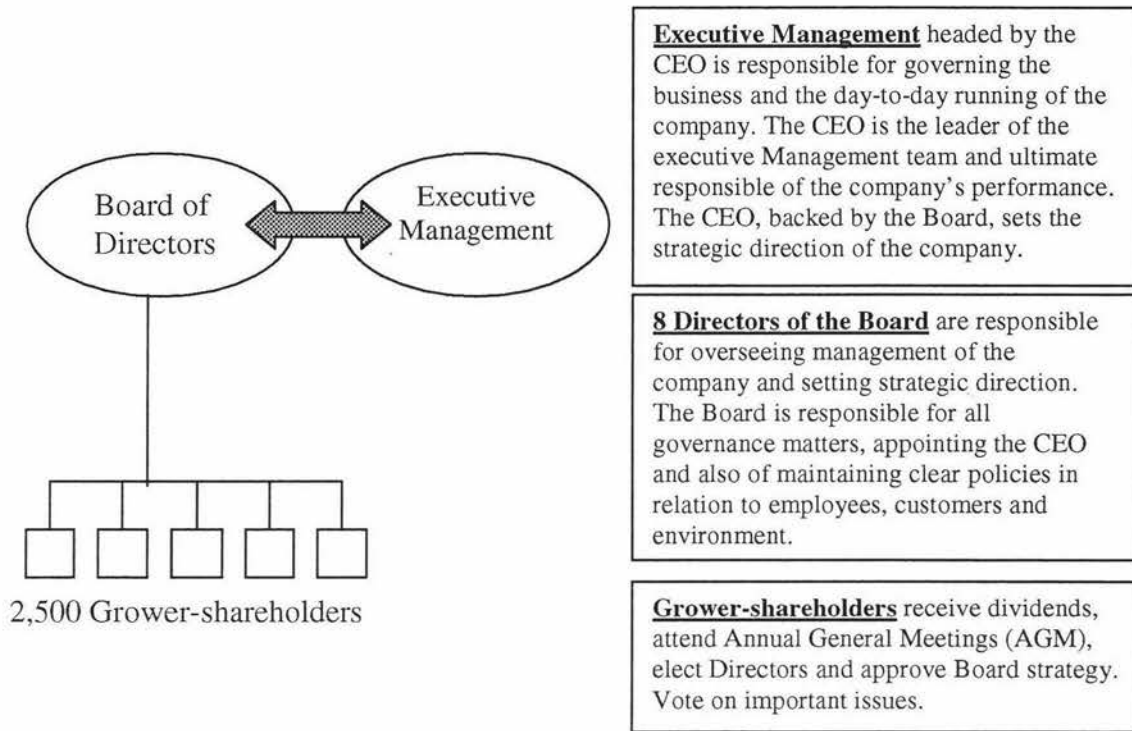
As of September 2002, Zespri's Board of Directors was as follows:

- Doug Voss, Executive Chairman of the Board
- Craig Greenless⁵³
- Alan Sutherland
- Graham Cathie
- Denham Shale
- Peter McBride
- Alistair Betts
- John Louglin

⁵² Alistair Betts, former senior executive of the NZDB (dairy industry) and John Louglin, former CEO of Richmond (meat industry) are both appointed-Directors in Zespri's Board, recently reconfirmed at the 2002 AGM.

⁵³ After December 2002, Craig Greenless will become Chairman of the Board.

Figure 13: Zespri governance structure.



5.4.5.1 New Zealand Kiwifruit Growers Incorporated (KGI)

KGI is the national organisation representing New Zealand kiwifruit growers. Established in 1993: “KGI was formed to give growers their own organisation with its ‘voice’ that would develop a secure and stable kiwifruit industry for the benefit of all growers” (KGI, 2002, p.1).

KGI is a grower-representative body, totally independent from Zespri, with no governing powers in Zespri’s structure. Still, Zespri’s governors and Executive Management interact directly with the KGI Forum using it for consultation purposes. KGI is funded from the pools, and indirectly, through KNZ, by Zespri.

KGI’s roles are to provide dialogue and communication opportunities for growers with Zespri and Kiwifruit New Zealand; to undertake a ‘watchdog role’ on behalf of growers to both Zespri and KNZ; to represent the various product groups to Zespri and the wider industry; and to ensure performance of suppliers, supply entities and other relevant industry groups by benchmarking them.

KGI's main structure is the KGI Forum, which is made up of 38 district-elected representatives with an additional four co-opted members from special interest groups. The members of the KGI Forum are elected by kiwifruit growers, on a district basis, every three years. In order to work efficiently and due to its large size (42 members), KGI operates internally with working groups that deal with specific areas such as supply and insurance, R&D, local market, environment and product groups (Green, Organic and Gold).

5.4.6 Capital structure

Zespri has a co-operative hybrid capital structure where only New Zealand kiwifruit growers can own shares, but growers do not have to own shares to supply to the company, in other words not all suppliers of fruit are suppliers of capital, or their shareholding in Zespri may not be in proportion to their submitted volumes, which means that within the company there are three categories of growers (grower-shareholders, non-shareholders growers and low-shrholders). Another peculiarity of Zespri's capital and ownership structure is that growers-shareholders can only vote in proportion to their production.

Although shares are fully tradable between growers and no cap exists in terms of limiting of shareholding (the existing 20% shareholding cap was eliminated) the shares market is relatively illiquid and in general terms shares are sold together with orchards. Shares are not quoted on the New Zealand stock exchange, but managed by an independent company and share prices and availability can be obtained by telephone. By March 2002, there were over 21.1 million Zespri shares issued and allotted, with no shareholders having more than 1% of the total shares (Zespri Annual Report, 2002).

As mentioned, Zespri operates from a commission of 11.4% charged to all New Zealand kiwifruit suppliers. Share dividends results from the company's profits minus retained earnings. Zespri paid in September 2002 a dividend of 7 cents per share, equivalent to NZ\$ 1.48 million, one year ahead of schedule, reflecting a gross return to shareholders of 8.7% on the \$1.20 share issue price. Still, dividends and share investment can be considered quite

incidental at the moment for kiwifruit grower-shareholders as fruit returns range from \$7 to \$9 per tray (according to fruit type) and estimates indicate that growers have about \$25-\$30 per tray invested in their orchards and only about 15-18⁵⁴ cents per tray invested in Zespri's shares.

"Some growers have said to me, we are not worried about buying shares, we are worried about growing fruit. But with the dividend coming out I think a few have changed their minds; I have heard of growers lately asking if they can buy more shares, whereas six months ago they wouldn't have thought about it" (Neill Malcon, Zespri Grower Liaison Manager, personal interview, July 2002).

In terms of its capital base, Zespri started with a very thin capital base of about \$3 million in year 2000, which located the company in a risky situation in front of the banks⁵⁵ and limited its ability to invest in growing the business. The manifested intention of the company is to raise its capital base up to \$40 or \$50 million by retaining earnings and by issuing shares.

Although after a partly subscribed capital issuing, where only 60% of shares were subscribed, the company announced in 2001 that it was looking at alternative ways of financing and increasing its capital levels, the fact is that no new mechanisms have been implemented and Zespri, by simply retaining profits has been able to increase its capital base to \$22 million and even pay a dividend to its shareholders of seven cents. It has to be stated that even though Zespri's capital base may soon be sufficient to cover most of its normal commercial risks, it is unlikely to be sufficient for offshore investment plans.

The issue of the existence of two or even three categories of growers within Zespri (depending on the point of view), has several implications⁵⁶. Some may be considered positive, as risk preferences are better reflected, and also, by separating core business from

⁵⁴ Calculated using a share value of \$1.5 to \$1.8 and considering that each issued share represents 10 trays of kiwifruit.

⁵⁵ Zespri annually borrows from banks about \$150 million for financing the crop until returns are received

⁵⁶ No official numbers exist in terms of the shareholders and non-shareholders quantities, but according to Zespri's sources about 90% of growers have some shareholding in Zespri.

value added activities the company is somehow ‘unbundling’ operations, but some may be negative implications as will be seen later.

5.4.6.1 Evolution of the capital structure

The original share entitlement was calculated in the year 2000 on the basis of one share for every 10 trays of kiwifruit produced per year (considering the 1997, 1998, and 1999 seasons for calculation purposes). Originally shares were fully tradable among growers, with a maximum of 20% on the number of shares that any grower could hold (this was changed later and no limit exist now). After shares were entitled some growers sold their shares, moved their shares into the post-harvest facilities or agreed to vote through the post-harvest operators.

Zespri’s original capital structure and financing mechanisms were criticised by certain sectors of the kiwifruit industry: *“I have only been able to identify disadvantages to growers and shareholders from Zespri’s current financial plans... To squeeze the maximum value from your Zespri shares, reject the capital raising proposals at the Annual General Meeting ”* (Alan Sutherland⁵⁷, kiwifruit grower, Orchardist Magazine, June 2000, p.32).

In February 2001 Zespri issued \$16 million in new shares, but it was not fully subscribed. Prior to the planned capital raising, a special general meeting was held and a production cap on voting was approved, with the intention of protecting Zespri from a corporate takeover. Doug Voss, Chairman of the Board, said: *“the change was driven by what happened with the apple exporter Enza last year, when corporate investors took control by buying nearly 40% of the shares from growers”* (Fencepost.com, 28 February 2001).

As initial shares were given to growers they did not have a price, but at the 2001 share issue the price was set at \$1.20. After the 2001 issue the price fell close to \$1.00, but after the company paid a dividend in September 2002 the share price has been reported to be at about

⁵⁷ In September 2001 Alan Sutherland became a Directors of Zespri’s Board.

\$1.80 per share. Although Zespri has not officially committed to further share issuing in the future, the possibility cannot be discarded as the company's necessity of capital still exist and interest in acquiring shares has been perceived from growers.

5.4.7 Knowledge creation and Research & Development (R&D)

Knowledge creation occurs at several levels of Zespri's value chain like development of new cultivars, growing techniques, post harvest technology and marketing of fruit among others.

According to the World Kiwifruit Review (Belrose, 2002) there are three key areas of innovation for fruit traders and producers in order to succeed in an increasingly competitive world with decreasing margins:

- New product development
- Reduction of costs and increase of efficiency
- Development of protocols to meet new standards in the marketplace

Zespri's main R&D hub is Zespri Innovation, a wholly owned subsidiary with an annual \$5 million research budget. The annual R&D budget, although represents only 0.6% of revenues, can be considered high in the fresh fruit industry: *"The innovation team is committed to the development of the Zespri business as a 'Learning System' that links industry data with data resulting from the research programme in an effort to enhance the accuracy of critical technology solutions"* (Zespri Workbook 2001, p.50).

The NZKMB was the first national Board to make a major commitment towards developing new kiwifruit cultivars. After the withdrawal of Tomua, a variety that had poor results, ZESPRI™ Gold kiwifruit was successfully launched by Zespri, first in New Zealand and later globally. Other fruit traders that have followed the same strategy (although not so successfully) of developing, licensing and marketing new varieties include Enza (Pink Lady apple) and Dole (Cameo apple).

Knowledge flow from Zespri to the grower base occurs in several ways and through different channels, which will be analysed in depth when discussing the communication and education channels. At the most basic level it consists of direct grower feedback approaching Zespri Innovation offices, located in Mount Maunganui. More structured channels include the Kiwifruit Journal, which has information on the outcomes of the research programmes; Zespri's grower website; Zespri Innovation Forum; and most important of all, through Zespri's Technology Transfer department.

A key component in terms of the Zespri-grower knowledge flow, the Technology Transfer Department's main role is to take the Zespri Innovation R&D outcomes and turn it into language that growers can understand and can be applied to their orchards, through field days and a series of seminars and documents, which they present to all growers over the course of the year. Also, the Technology Transfer department interacts with supply companies and their technical officers.

On the other hand, the knowledge flow within the company occurs in more informal ways and is facilitated by the fact of having centralised offices where both Zespri Innovation and Zespri International staff are based.

5.4.7.1 Zespri Innovation

Zespri Innovation Company Limited was established to: *“lead the timely design and delivery of kiwifruit research and development solutions to enable Zespri to be the preferred international marketer of kiwifruit. It will retain its current contribution to the group, working with all entities”* (Zespri Workbook 2001, p.49). Zespri Innovation's aim is to address the gap between research providers and the research users in Zespri and the kiwifruit industry. According to the company, Zespri Innovation key projects during the 2001/2002 season included: development of systems and models for transporting and appropriate ripening of the fruit, improvements in its new cultivars programme, development of on-orchard technologies, and funding of postgraduate study in New Zealand universities.

Zespri Innovation is structured around four main research disciplines:

- Fruit quality
- Environmentally sustainable crop production
- Logistics (including cool-chain)
- Value-added and new cultivars

Each area is headed by an Innovation Leader, responsible for assisting in the identification of critical areas for research, together with the research users and for working closely with research providers.

Once researchable areas are identified research projects are then contracted out to research providers, who do the work and report back to Zespri Innovation, which in turn link it to the research users. Research providers include a range of organisations such as Crown Research Institutes, Universities and private providers within New Zealand, as well as offshore providers (Figure 14).

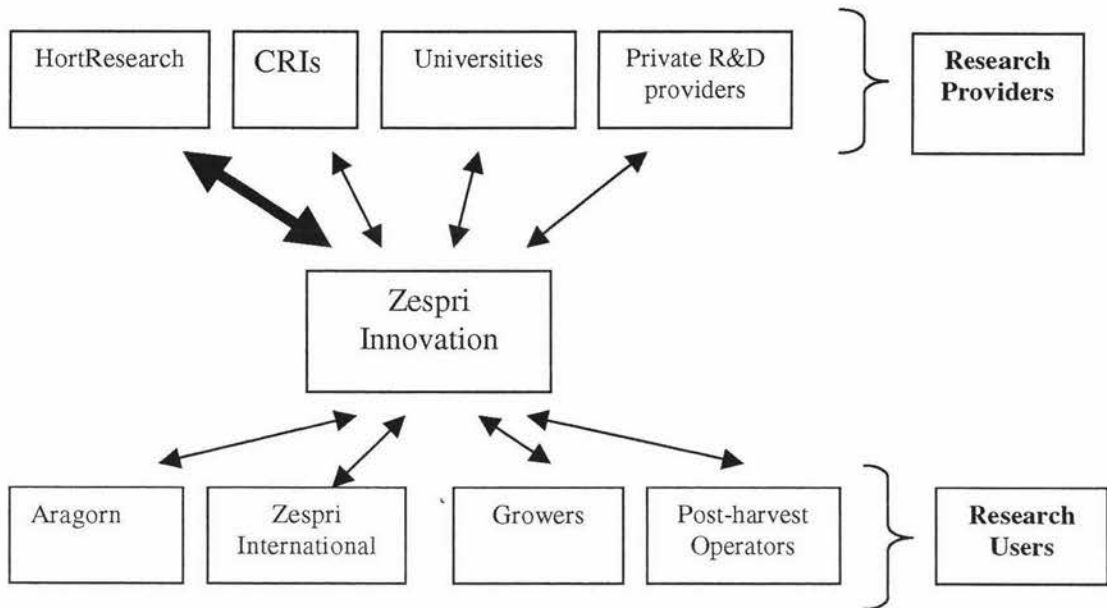
The development of new products and cultivars is an important R&D area in the fresh fruit industry, which has proved to be an extremely difficult, risky and expensive task. Challenges arise from the long time span between initial selection of promising cultivars and their first introduction to commercial markets. According to Belrose (2002) the industry must expect to incur development costs for 10 new cultivars in order to find one successful variety that performs both at market and orchard level. The unsuccessful Tomua variety is a good example of the previous point. Also, the protection of proprietary rights in the fresh produce industry used to be a difficult issue, a situation that is changing under after the Uruguay Round of the WTO.

On the other hand the rewards of owning a successful product are also big, as Zespri is finding with its ZESPRI™ Gold kiwifruit variety in the Asian markets and lately in Europe. Zespri has exclusive rights for a period of 20 years for commercialising ZESPRI™ Gold kiwifruit, and although there are already competitors in the market with other yellow-fleshed

varieties, Zespri has a leading advantage that according to Zespri’s CEO, Tony Marks, is of at least six to seven years.

Zespri’s R&D expenditure (0.6% of net revenues), although not large if compared with multinational food companies, is considered substantial for a fresh fruit marketer. It is likely that due to the success ZESPRI™ Gold kiwifruit is experiencing and the considerable R&D budget, that new varieties come out of Zespri Innovation, although timeframes have not been defined: *“Would be forthcoming in the next few years more new varieties? Considering what we are spending on research, there should be some more new varieties”* (Doug Voss, Orchardist magazine, March 2002, p.37).

Figure 14: Zespri Innovation R&D diagram.



Key: thicker line implies a stronger relationship

5.5 Zespri’s internationalisation

5.5.1 Business internationalisation

Based on the model being used for this study (see Figure 2) we find that Zespri is involved in four out of the six foreign market service modes: export, FDI, external sourcing and knowledge agreements. The first two have been the ones traditionally used by Zespri (and previously by the NZKMB) and only in recent years has Zespri slowly started to externally source product and to license its ZESPRI™ Gold kiwifruit variety.

Internationalisation as defined by this study has always been present in Zespri's business strategy and when the name 'Zespri' was chosen it was fundamental to select a name with no linguistic or geographical limitations. For Zespri, as a company with a 99% dependence on international sales, gaining and maintaining market access is critical. This was originally achieved by traders and further on by establishing representation offices and finally by establishing subsidiaries in selected markets⁵⁸ (Figure 16).

The company has defined further internationalisation, beyond exporting, as essential for the company: *"The development of offshore enterprises is the cornerstone for growth. It will enable us to enhance our leadership of the kiwifruit category, strengthen retail and consumer relationships, extend our influence through leveraging the ZESPRI™ brands and ZESPRI™ system and maximise future returns to both Zespri and Kiwifruit International shareholders"* (Tony Marks, CEO Zespri, Kiwiflier, September 2000).

The reasons for internationalisation can be found on several streams, first the increasing pressure from retailers to be supplied on a 12-month basis, maximisation of infrastructure costs, as well as the reduction of marketing costs associated with re-launching the product and brand every year, among others. The previous reasons added to the possibility of incrementing its market share by internationalising its marketing and capabilities made external sourcing and offshore licensing the logical next steps.

Zespri is a company with 25-30% world market share, achieved almost exclusively by exporting from New Zealand to the Northern hemisphere countries, in the Northern hemisphere summer when they do not have product. By internationalising, the company aims to increase its market share while at the same time responding to the market pressures of year-round supply.

As current legislation in the New Zealand kiwifruit industry prevents Zespri from 'risking growers money by investing offshore', a separate company, Kiwifruit International has been

⁵⁸ For a more detailed study of the NZKMB, Zespri's predecessor, see Enderwick & Akoorie (1996).

set up in order to somehow overcome the legislation and isolate New Zealand growers from offshore risk by underwriting Zespri's offshore activities.

5.5.1.1 Foreign Markets Service Modes (FMSM)

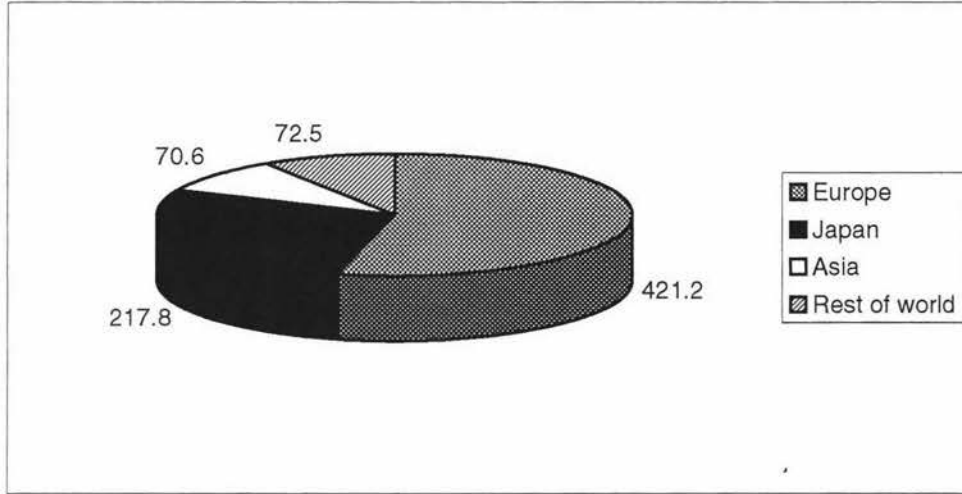
5.5.1.1.1 Export

Although exporting is by far Zespri's main foreign market service mode, most of the volume is handled through subsidiary offices and therefore qualifies as FDI (see FDI service mode below). In markets where volumes are low and Zespri doesn't have subsidiary offices the company uses traders or other export arrangements.

As defined in its annual report 2001, Zespri's exporting strategy is to target Europe as the high volume and strong value market, Japan and selected Asian countries as premium markets (kiwifruit prices in Japan are generally 50% above the average global price) and North America for absorbing the extra ZESPRI™ Green and ZESPRI™ Gold kiwifruit. By spreading markets the company is able to buffer the impact of low prices in any determined market, even though the company is highly dependent on Japan and Europe, as can be seen on Figure 15.

Because of New Zealand's counter seasonal nature, which means that in general terms Zespri starts trading New Zealand Kiwifruit when the local Northern hemisphere kiwifruit season is over, Zespri has no problems in terms of market access in any country of the world where it trades fruit. The only exception to that rule happened in the US in 1992 when the NZKMB was accused of dumping product in the US market and was effectively banned by the US government from that market for eight years and has been only recently able to re-enter.

Figure 15: Zespri's export revenues, 2001-2002 (NZ\$ million).



Source: Zespri Annual Report 2002.

5.5.1.1.2 Foreign Direct Investment

As already described Zespri International has a number of subsidiaries, but the world is essentially divided into two marketing arms, one of them is Zespri Europe with its headquarters in Belgium, which has subsidiaries in France, Spain, Italy and the UK. The other marketing arm is the Asia Pacific, which is based in Japan and includes the Americas-Asia Pacific area and it also has subsidiary offices in Korea and Taiwan (see Figure16).

Zespri also has a minority equity interest in a North American multi-product trading company, David Oppenheimer & Company, which handles the importing of ZESPRI™ Gold and ZESPRI™ Green kiwifruit into the US and even though the US is not currently a significant market for Zespri in terms of returns and volumes, partly due to the 8-years ban that affected New Zealand kiwifruit, the potential for growth is considerable.

As described by Enderwick & Akoorie (1996) the opening of the Japan subsidiary company, Zespri International Japan Ltd., by the NZKMB back in 1992 provides an example of how the

original establishment of subsidiaries was done in order to get closer to the final customers eliminating intermediate stages, gaining market power and therefore maximising returns. Historically the NZKMB would sell kiwifruit to any Japanese importer willing to pay, selling directly to wholesalers and developing its own nationwide importing and storage network. In the next stage the NZKMB began working more closely with retailers, which by that time were starting to play an increasingly important role in fruit sales in Japan, gradually reducing the role of wholesalers in the distribution chain of kiwifruit. In 1990 a representative office was established and then finally in 1992 a subsidiary company established.

5.5.1.1.3 External sourcing

The 12-month supply business strategy based on the complementing of New Zealand grown kiwifruit with externally sourced fruit is proving hard to achieve for Zespri. After three seasons, problems in ensuring quality and sufficient volumes have kept the strategy still in its infancy and even delivering negative numbers as it did in 2001-2002.

Zespri intends to source kiwifruit grown under contractual relationships through its ZESPRI™ System from Northern hemisphere countries, mainly Italy, but also from France and California in the US (and potentially from Chile) in order to complement its New Zealand based kiwifruit season, to be able to supply selected customers with kiwifruit to assured specifications and assured quality standards on a 12-month basis.

Zespri charges an 8% commission on externally sourced kiwifruit (relatively standard in international fruit trading markets), which is in fact lower than the 11.4% charged to its New Zealand suppliers, as the company is involved in a range of other activities onshore (e.g. technology transfer department) that are not performed offshore.

The first trials of externally sourced product were done by the company in 1999 with ZESPRI™ Green kiwifruit being sourced from Italy and Iran and as expected for a first year, quality problems emerged causing the Italian fruit to be sent mostly to the East Coast of USA and East Asian markets and Iranian fruit to smaller markets in the Middle East and Asia, proving to be a step leaning curve for the company.

In February 2000 Zespri marketed 425,000 trays of Iranian kiwifruit under the Caspian Label brand, but it was not until 2001 that the first Zespri-branded externally sourced kiwifruit was marketed, when Italian-sourced ZESPRI™ Green, ZESPRI™ Gold, and ZESPRI™ Organic kiwifruit began appearing on selected European markets.

Season 2001/2002 was officially launched by the company as its first season of continuous supply, but as the company stated on its Annual Report: *“the 12-month business, based on the procurement of quality ZESPRI™ Green kiwifruit to provide selected customers with continuous supply, did not perform to expectations due to the difficulty in procuring sufficient volumes of quality product from Italy”* (Zespri Annual Report 2002). The result was a \$136,000 financial loss underwritten by Kiwifruit International.

5.5.1.1.4 Knowledge agreements (licensing)

ZESPRI™ Gold kiwifruit, the variety developed by HortResearch and commercially owned by Zespri, was the circuit breaker that allowed the company to enter into licensing agreements rather than just marketing externally sourced product.

Zespri International manages the licensing, harvesting and distribution of Hort 16A variety, commercially known as ZESPRI™ Gold kiwifruit. Licenses are granted to selected growers purchasing plants or graftwood, or even using their own graftwood to propagate their own plants. Zespri, as licensor, must be informed of any changes to plantings, changes of property hands or leasing of land with ZESPRI™ Gold kiwifruit plants. The licensing contractual relationship indicates that Zespri owns the plant variety rights of ZESPRI™ Gold kiwifruit, the selected growers grow the fruit on behalf of the company, who finally takes the fruit and markets it under its ZESPRI™ System, charging the grower a marketing commission. ZESPRI™ Gold kiwifruit has been licensed to growers in New Zealand as well as offshore, although different marketing commissions apply.

By the time this study was being done (2002) there were over 300 hectares of ZESPRI™ Gold kiwifruit being grown in Italy by selected producers, some of them co-operatives

(Spreafico in the south of Rome, Apoconerpo in Bologna, Apofruit in Cesena and AFE/Salvi in Ferrara) plus another 300 hectares being grown in California, as well as small areas in France and Japan, summing a total close to 700 hectares growing offshore.

As the company has admitted⁵⁹ offshore licensing is moving slower than the company would like. Considering that there are currently about 2,000 hectares of ZESPRI™ Gold kiwifruit planted in New Zealand and that the intention of the company is to complement New Zealand production, the current 600-700 hectares area is a third of the ideal area, even though plantings in New Zealand have been momentarily stopped. An additional incentive to make this strategy work is the fact that the ZESPRI™ Gold kiwifruit variety is proving to be extremely successful in the Japanese and European markets.

The reasons for the slow pace of the offshore licensing include among others the caution of offshore growers in planting a new relatively unknown variety which has no growing history in their environments, as well as the fact that the licensing of varieties is in general terms a new business relationship for fruit growers worldwide. The company needs to increase more quickly its offshore licensed area through strong technical support, aggressive marketing and/or offshore investment.

5.5.1.1.5 The possibility of having overseas growers-shareholder and becoming a transnational co-operative hybrid

Although Zespri has repeatedly manifested its intention of remaining New Zealand grower-owned and controlled and it is not part of the current strategy to accept overseas grower-shareholders, the apparent benefits that can be obtained from having international supplier-shareholders and overseas growers' manifest interest in getting into partnership arrangements with Zespri, makes the possibility worthy of analysis: "*Partnership arrangements offshore could also help to truly internationalise kiwifruit production*" (Tony Marks, CEO Zespri, Orchardist Magazine, March 2001).

⁵⁹ Doug Voss, Kiwifruit Journal, July 2002, p.8.

Zespri is currently working closely with Italian and North American growers. This close collaboration implies that technical assistance is being provided to overseas growers by New Zealand specialists and also that overseas growers are being trained in New Zealand. Therefore the possibility that over time these contractual relationships evolve to partnership agreements and even shareholdings is not unreal.

“I think that there are psychological and positional advantages in being able to be inclusive with all our suppliers whether they are onshore or offshore, by having a shareholding opportunity for offshore growers, although this is a very futuristic statement, my own opinion and not that of Zespri or part of the current strategy” (Doug Voss, Zespri Chairman, personal interview, September 2002).

If Zespri eventually decides to introduce offshore growers as shareholders there are several structural, legal and cultural barriers it has to overcome, the last one being probably the most difficult. From the New Zealand growers’ point of view and according to people involved in the industry, it is probably fair to say that the majority expectation would be that control and ownership of Zespri would always remain with New Zealand growers.

At this specific point in time (September 2002) Zespri’s short-term priorities on the international side are on making the 12-month supply strategy work as both the external sourcing of ZESPRI™ Green kiwifruit and the offshore licensing of ZESPRI™ Gold kiwifruit are proving difficult to be implemented, although the internationalisation of shareholding could be an impulse for this to happen.

5.5.2 Knowledge and capabilities internationalisation

5.5.2.1 Zespri’s core capabilities

“The integrated ZESPRI™ System is the principal strength that delivers customers quality and certainty under a trusted brand” (Zespri Workbook, 2001, p.5).

Although Zespri can be considered a 'virtual company' with no fixed assets (something that could be in fact considered as one of its biggest competitive advantages), Zespri's influence goes far beyond the simple marketing of fruit, including R&D, supply quality systems development, etc. ZESPRI™ system is the name the company has given to the management and quality systems that link the various steps in the value chain from orchard to retail.

Zespri's marketing capabilities were recognised in 1998 when Zespri International was named the 'Exporter of the year' by Trade New Zealand based on overall market performance, strategic innovations and efficiency. Also, R&D has proved to be a core capability for Zespri and the most visible face of that is ZESPRI™ Gold kiwifruit variety, which represents an important competitive advantage.

An important factor that represents one of Zespri's main comparative advantages is its single New Zealand exporter status. Due to it Zespri controls two thirds of the Southern hemisphere supply season and is able to almost dictate prices in the marketplace. At the same time the New Zealand export monopoly powers allow Zespri to enforce quality standards from its suppliers.

"What Zespri is able to do on behalf of New Zealand growers is go out to the market place set a price and for all the customers know that that is the price, there are no special deals, and that nobody else is going to get a better deal than they have. Our credibility with our customers is critical" (Peter Luxton, Global Marketing Service Manager, personal interview, July 2002).

Unlike its management systems, R&D and exporting capabilities, the single exporter power is not something that Zespri can leverage internationally and is in fact a comparative advantage that Zespri could eventually lose, therefore it is critical for the company to build on its other competitive advantages.

A very important point that needs to be answered is: are Zespri's New Zealand growers-shareholders a source of competitive advantage for Zespri? If answered strictly from the

financial point of view the answer is no, as differences in the marketplace exist mainly on the marketing price rather than the production costs (Table 22). So unlike New Zealand dairy farmers, New Zealand kiwifruit growers do not have the lowest production costs of the world, although yields per hectare are considerably high, averaging 21 tonnes/ha, ahead of kiwifruit growers from Chile (19 tonnes/ha), France (17 tonnes/ha), and Italy (14 tonnes/ha) (HortResearch, 2000).

On the other hand, if the same question is answered from a different point of view the answer is that Zespri’s shareholders, New Zealand kiwifruit growers, have been a continuous source of innovation for the world kiwifruit industry and are responsible for the development of the Hayward variety and the name ‘kiwifruit’ among others, therefore representing a competitive advantage for the company.

Table 22: Comparative analysis of net prices and profits of kiwifruit growers from selected countries (figures in US\$/kg).

	NZ Green	NZ Organic	NZ Gold	France Green	Italy Green	Chile Green	USA Green
Net Price	1.28	1.29	2.05	1.00	0.68	1.09	1.18
Production Costs	1.01	1.01	1.72	0.86	0.61	1.03	0.99
Net Profit	0.27	0.28	0.33	0.14	0.07	0.06	0.19

Source: International Kiwifruit Organisation, IKO (2001) cited in Zespri Workbook (2001).
 Note: production costs include: growing + harvesting + post harvest + marketing (freight included).

5.5.2.2 Capabilities internationalisation

Zespri has reported to be currently investing in on-ground support in Italy and the United States to help licensed ZESPRI™ Gold kiwifruit growers produce the volume and quality of fruit required, and also to assist in the external procurement of ZESPRI™ Green kiwifruit to brand specifications.

By internationalising its ZESPRI™ System, Zespri is in fact leveraging its core capability: *“The integrated ZESPRI™ System is the building block for the pivotal growth strategy of*

controlled offshore ZESPRI™ Gold kiwifruit production and ZESPRI™ Green kiwifruit sourcing and marketing” (Zespri Workbook, 2001, p.5).

Although some risks associated with the internationalisation of capabilities exist, the benefits outweigh the risks and replicating the quality systems offshore represent the only viable way to protect Zespri’s brand from damage.

Originally Zespri sourced non-New Zealand kiwifruit under alternative brands reserving the Zespri brand for kiwifruit of New Zealand origin only, but in 2001 the company started to market externally sourced kiwifruit under the Zespri brand, and according to the company, achieving substantial premiums over competitor kiwifruit, although volumes have been insufficient.

In order to internationalise its quality standards and management systems, Zespri has developed three new roles: an International Supply Manager, responsible for establishing offshore plantings and setting up operational systems offshore; a Quality Overlay Manager, responsible for working with offshore supply partners to implement Zespri standards; and a Technical Transfer Overlay Manager responsible for working with onshore and offshore supply partners to transfer ZESPRI™ System intellectual property.

In terms of the internationalisation of Zespri’s R&D capabilities, the possibilities are still on a planning phase: *“This team is quite new and we envisage that as years come through we expect to be able to provide some aspects of the system to our offshore suppliers through us, so we could exchange things with them on a contractual basis, but that doesn’t exist yet, we are looking at it”* (Nigel Banks, Zespri Innovation Manager, personal interview, July 2002).

5.5.2.3 Knowledge internationalisation

As stated before, Zespri has been traditionally an exporting company and its only recently getting involved in other FMSM such as external sourcing and licensing, therefore knowledge internationalisation can be considered to be at its infancy at the moment, but it can be

expected that as those relationships grow in time they would provide information on research issues that need to be addressed, such as alternative ways of growing kiwifruit, and all sorts of matters ranging from growing to marketing of kiwifruit.

On the other hand, although some fears may exist among the grower base in terms of 'giving away' a competitive advantage by, for example, internationalising the newly created ZESPRI™ Gold kiwifruit variety, the company is committed to the protection of its variety rights through enforcing mechanisms, including DNA tracing technology, and helped by the reigning atmosphere of international proprietary rights protection pushed by the WTO.

5.6 Integrative structures

5.6.1 Governors/growers interface

As already seen, Zespri has a very flat governance structure consisting only of grower-shareholders, Directors and executive Management (headed by the CEO). For keeping a close governors/shareholders interface, Zespri has in its favour the number of growers (2,500) which although not small, it is still manageable. Also in favour of the company is the geographic concentration of its grower base, with 85% of its grower-shareholders being based in the Bay of Plenty region. Therefore grower-Directors have an easier task when interacting with its shareholders than governors of larger and more dispersed co-operatives.

Zespri CEO's tasks, demand of him that besides fulfilling his strategic leadership role being the ultimate responsible for the company's performance, to spend a considerable amount of time meeting with grower-shareholders, including going out on Roadshows four times a year.

With five grower-Directors, each grower-Director represents an average of 500 growers, giving Directors a reasonable proximity to its shareholders. On the other hand the three appointed-Directors interface with growers is far more limited as in general terms they do not

tour around the growing areas or assist frequently at meetings with growers, instead they spend the majority of their time dedicated to the company on governing the business, setting the strategic direction of the company and visiting the markets and international operations of the company.

The already mentioned KGI, although a totally independent grower representative body, whose aim is to operate as a consultative channel also represents a valid interface between Zespri and the kiwifruit industry. For that purpose, besides assisting eight times a year to the KGI Forum and updating the 42 representatives on operational and strategic issues, Zespri's Directors and also the Executive Management staff (in a more limited way) interact directly with KGI's leaders (i.e. KGI President).

Each KGI member represents growers from his/her own district, so in theory when growers have a concern they go to their local representative and that local representative goes to the KGI president or KGI's Executive Officer whom in turn takes the issues back to Zespri. Having said this, the efficiency of the interface growers-KGI-Zespri has been questioned over recent times: *"I think KGI still struggle to get good communication back to growers but they recognise this. They are honest about it and are working on it"* (Doug Voss, Zespri Chairman, Kiwifruit Journal, July 2002, p.8).

5.6.2 Company/growers interface

In Zespri's current supply structure there is a triangle made of growers-suppliers-Zespri, where day to day operational and logistical interface is between Zespri and suppliers, with growers having no automatic rights to related information and also (and maybe more important) as Zespri has the contractual relationship with suppliers, payments go to suppliers who in turn deduct their costs and commissions and then pay growers.

In general terms the current supply structure means that Zespri deals with twelve suppliers who are in charge of the logistics, under suppliers there are supplying-packhouses and then below the packhouses there are a number of growers, although some growers contract directly

with suppliers. Therefore, growers are either two or three stages away from Zespri for both operational as well as financial issues. The structure, although with some efficiency benefits, has been identified as a source of concern, especially for growers who feel disconnected from Zespri.

In direct response to growers' concerns of being disconnected from Zespri, the company established a new position in year 2001, Grower Liaison Manager. Currently Zespri has two Grower Liaison Managers whose function is to work as a two-way communication structure; downwards they present latest operational information and market summaries and clarify existing doubts to growers; upwards they listen to feedback from growers on topical issues.

The Grower Liaison Managers' job is in the field, where they spend most of their time at pre-arranged meetings with groups of growers, as well as attending Fruit Associations meetings, packhouses and suppliers' meetings, etc. Physical limitations exist with only two people covering 2,500 growers. Grower Liaisons spend their remaining time at Zespri's offices planning as well as interchanging information with executive management staff, although some of the information exchange mechanisms are still in the development phase.

Another fact to consider is that as a consequence of the company's move from Auckland to Mount Maunganui (Bay of Plenty region), at least physical distance is minimised and according to Zespri staff the issue is reflected in growers constantly showing up to question staff on topical issues.

In a collective way, Zespri interacts with growers at the KGI Forum (eight times a year), which provides an opportunity for growers and grower's representatives to interact with Zespri leaders. However, as already mentioned, the efficiency of the KGI forum has been questioned: "*Prior to corporatisation KGI was seen as a legitimate vehicle that gave voice to grower issues and concerns. KGI has remained stable in structure and purposes since its conception, but in recent times has been criticised for not performing to its potential and is seen as ineffectual*" (Zespri Workbook 2001, p.14).

While the interface with growers is identified as an area where Zespri needs to work, the interface with suppliers is far more structured. The interface is at two levels: first there is a

Chairman's forum where Chairman and Chief Executives of the suppliers meet with the Board and senior management of Zespri once every two months to discuss strategic issues; on the alternative months there is a supplier's forum where Managers of each one of the suppliers meet with middle managers of Zespri to discuss operational issues. Also a bi-weekly newsletter called 'Up to date' goes to all suppliers and all post-harvest, pack-houses and cool-stores, communicating technical operational issues.

However as admitted by the company, the supply structure requires ongoing work and is currently under review. Some of the alternatives being evaluated were included in the Zespri's Workbook sent to all growers in September 2001. Alternatives include from retaining the status quo to splitting contracts, with growers being contracted for the fruit and suppliers being contracted for logistics and service. Another possibility is the reestablishment of contractual relationships between growers and Zespri leaving suppliers as service providers to be contracted out by growers: *"I believe money should go to growers, and the relationship with suppliers and post-harvest operators should be only of service providers; and I believe that it was a mistake to give suppliers control over the money"* (Grant Eynon, KGI Chairman, personal interview, August 2002).

However, the operational and financial implications over the current information and payment system, of increasing contracts from twelve to 2,500 should not be underestimated.

5.7 Integrative mechanisms

5.7.1 Communication

Zespri needs to be constantly communicating with its growers and with its suppliers (due to the current industry structure), informing them what the company is doing both onshore and offshore. Specifically related to the topic of this thesis, Zespri has to communicate with growers (within commercially-sensitive boundaries) the details, implications and logics

behind its international business relationships, the FMSM being used and the evolution of its year-round marketing strategy.

As the company is moving from being a simple exporter of New Zealand kiwifruit towards becoming a year-round marketer, involved in external sourcing and licensing of kiwifruit, the company have had not only to communicate but also to explain these issues to growers; therefore communication has strong links with education, with information transfer and knowledge transfer being often synonymous. In other words, in most cases while the company is communicating it is also educating its grower-shareholder base. Well-informed growers will play a key role in Zespri's future development. Poorly informed and poorly educated growers instead, can become a limitation for the company and a barrier for further internationalisation.

Zespri as a co-operative hybrid stands somewhere in the middle between co-operatives and corporations, but probably it is when analysing the communications scheme that Zespri has in place, that one can classify the company far closer to the co-operative type, in terms of the amount and frequency of information exchange, as well as the different channels of communications the company has with its growers and shareholders. Having said this, there are still concerns among the grower base related to the lack of communication between Zespri and them.

In a pure corporate company (IOF) communications are in general terms restricted to Annual General meetings and a limited amount of company statements without entering into great detail about specific investments. In contrast, in a co-operative type company like Zespri, grower-shareholders are interested in the source of the profits, results by product type, country, etc, in other words a larger amount of detailed information. Also, the company's ability to communicate, consult and get member endorsement for a specific strategy is an important part of the strategy's success.

"In a co-operative-type company if you do your consultation and communication right, you actually get more leeway if the numbers don't perform quite as well as expected in any given year. An example for ZESPRI would be our first year of 12 month marketing, which wasn't

that successful for a variety of valid reasons, but we've had hardly any reaction from the growers, why? Because the proceeding 3 years all we've talked about is the commercial rationale underpinning our 12-month marketing strategy; this understanding and transparency helps when you have a less than perfect result" (Todd Muller, Industry Relations Manager, Zespri Group, personal interview, September 2002).

Because of the existence of different product groups of growers (Green, Gold and Organic), different growers associations and different suppliers, all of them distributed in different geographic locations, Zespri has to communicate all important issues constantly, particularly the strategic ones, repeating them at every meeting and through the different communication channels.

There are two key issues that must be analysed in order to understand the nature of Zespri's communication scheme. First there is the existence of supplier entities and the already explained Zespri-suppliers-growers industry structure with the implications it has in the information flow. Second is the existence of two categories of growers, shareholders and non-shareholders, and the implications in terms of communications.

With respect to the industry structure and the implications it has for communications, these implications are significant as all operational, logistical and most of the financial information in terms of amounts, cash flows and timings, flow from Zespri to suppliers, who in turn have to communicate down to growers on these issue. As a consequence of this, some growers feel uncomfortable with the information flows and the system is currently under review.

In terms of the existence of shareholders and non-shareholders among the growers; although in theory communication could get affected by the existence of two broad categories of growers and information could represent a potential advantage for share value purposes, the fact is that the majority of growers (about 90%) have a shareholding in the company. Therefore, Zespri does not make a significant distinction between shareholders and growers, except for the Annual Report, which only goes to grower-shareholders; all the remaining information goes to all growers (suppliers of fruit) irrespective if they are shareholders or not. In other words, Zespri communicates with growers as a single block.

The forms and channels of communication used to reach all growers are a key part in the result. Among the various internal communication mechanisms (face-to-face, printed and electronic) that Zespri has in place for communicating with its grower-shareholders, the most important ones are listed and briefly explained below.

5.7.1.1 Face to face communication mechanisms

(I) Annual General Meeting: The Annual General Meeting (AGM) represents the main opportunity for Zespri's 2,500 grower-shareholders to receive reports on financial and operational annual results of the company and topical issues directly from the Board of Directors and Executive Management. At the AGM grower-shareholders also have the chance of challenging their governors about the direction of their company. The AGM is held at one venue and the opportunity is also used for voting and electing or re-electing Directors.

(II) Road shows. Zespri runs four Roadshows every year (February, April, August and November) around the major growing areas. Roadshows are presented by the Chairman of the Board and the CEO, focusing on strategy, key issues and financial and market performance, representing an opportunity for growers to question directly the two key leaders of Zespri.

Roadshows are generally one-hour presentations, but vary their content according to the time of the year and key issues at that specific moment. In general terms, the February Roadshow deals with supply domestic type issues; at the April Roadshow goals by market and product are presented; at the August Roadshow, the same goals are repeated and the comparison with current performance is done; and finally in November the same scheme is repeated with a more accurate idea of the season's performance. Company estimates indicate that about one quarter of all growers show up to these meetings.

(III) KGI Forum. Members of the Board and senior executives of Zespri meet eight times a year with KGI representatives at the KGI Forum. KGI representatives in turn disseminate the information away to all the growers, helping partly Zespri to get the information out. The KGI

Forum is used by Zespri to update KGI on market and operational issues, as well as the company's strategic plans for the future. KGI representatives use the forum to request from Zespri information about how the company is performing or any strategic issues. KGI in turn elaborate an information sheet called KGI Update that goes to all growers communicating the issues and topics dealt at the KGI Forum. Beside KGI representatives, growers can also attend and ask questions of Zespri representatives themselves.

(IV) Grower Liaison Manager meetings ('Under the Vines' meetings). 'Under the Vines' meetings are basically informal discussion meetings with two-way information flows. Grower Liaisons present to growers latest operational information and market summaries and at the same time listen to feedback and concerns from growers on topical issues. The aim of the meetings is to complement Zespri's Roadshows and in fact attract growers that do not attend the company's Roadshows. It has to be stated although, that there are obvious physical limitations for only two Grower Liaison Managers meeting with 2,500 growers.

Zespri's two Grower Liaison Managers prearrange meetings with groups of 20-25 growers for meeting at a certain orchard; in total they held about 35 of these meetings during the year. As meetings group growers from a determined geographic area, the meetings represent a good opportunity to discuss potential problems of that specific region.

5.7.1.2 Printed communication mechanisms

(V) Annual Report. Annual Reports are sent to all grower-shareholders summarising the company's performance and key figures for the year, in terms of product and markets as well as detailed financial information of Zespri Group. The Annual Report also goes to subsidiaries and business partners worldwide. Electronic versions can also be downloaded from the company's website.

(VI) Kiwiflier: A monthly newsletter sent to all growers highlighting strategic issues, operational and market updates and supplier financial information including payments information and forecast return to suppliers (by product and variety). Additional information

includes future and current activities. The Kiwiflier's format was changed in April 2002 into a newsletter-type of document rather than a Magazine-type one following growers' feedback.

(VII) Kiwifruit Journal: A bimonthly publication of magazine format that includes longer articles and interviews, treating key industry issues. The Kiwifruit Journal also includes articles from Zespri Innovation. The Kiwifruit Journal goes to all growers and industry stakeholders, having therefore a wider circulation than the previously mentioned mechanisms.

(VIII) Operational updates: In addition to the Kiwiflier, Zespri publish three times a year an insert called Operational Update that presents strictly onshore operational information including harvest issues, quality updates, onshore insurance information and others.

(IX) Grower letters: Zespri sends letters to growers as required with information related to weather conditions, governance issues, financial and capital raising issues or any other topical issue.

5.7.1.3 Electronic communication mechanisms

(X) Zespri-grower.com website. The website (www.zespri-grower.com) allow growers to access on-line copies of best practice orchard management manuals and orchard management tools (Dry matter index calculators and Hort16A Maturity Index calculator). The site also electronically holds presentations, technology transfer seminars, Kiwifliers, Kiwifruit Journals and most communication mechanisms used by Zespri. As the website may have some commercially sensitive information its access is restricted to registered growers. According to Zespri, about 300 growers are connected at the moment (12-15% of growers).

(XI) Zespri's website. The company's website (www.zespri.com) offers company information and general information about the New Zealand kiwifruit industry. The site represent mainly a marketing tool for outside visitors .

5.7.1.4 Other communication mechanisms

Although the previous list tries to describe the main mechanisms Zespri uses to communicate with growers and shareholders, it is not a totally inclusive list. Other mechanisms like personal interaction between growers and Directors or Zespri representatives, field days, casual meetings of Directors with growers, appearances of Directors of the Board and senior Executives at industry events, fruit growers associations, public speeches, etc. All of these represent communication mechanisms used by the company that help to spread information around the grower base.

Also important to highlight are other integrative mechanisms that help to develop ownership feeling among the grower base, bringing grower-shareholders closer to the company. The Zespri Industry Challenge is a good example in that respect, consisting of a family field day with activities that include a half marathon, prize giving, team contests, children's activities, etc., and where growers and their families interact with their peers and the company's staff.

Zespri's Offshore Study Tours represent another good example of an integrative mechanism by which the company gets closer to its grower base, develop ownership feeling of its grower-shareholders and at the same time raise their knowledge level. The tours are self-financed by growers but organised by Zespri and led by Zespri staff. Tours include visits to wholesalers and retailers, fresh markets, ports and orchards among others. Year 2002 Offshore Study Tour went to Europe and future tours may include visits to Japan, Korea, Taiwan, Chile, Spain, UK and North America.

5.7.2 Members education and up-skilling

The education and up-skilling of grower-shareholders happens on different fronts such as technical up-skilling (growing techniques, pest management, etc) and the education of grower-shareholders in terms of the understanding of the company's functioning and the

environment in which it operates. For the purposes of this study we will mainly concentrate on the second one.

When analysing the education and up-skilling of grower-shareholders we have to consider grower-shareholders, grower representatives and Directors. A key issue in this respect is the education of the grower base with the purpose of forming potential leaders (i.e. Directors) that can lead Zespri in the future. Also, the education of growers is important in order to understand the company's strategy and environment in which the company operates, which in turn plays in favour of the company in terms of support when eventual strategic shifts or capital needs arise.

The New Zealand kiwifruit industry and Zespri as part of it, have traditionally relied on the arrival of talented people from other industries and from a range of backgrounds (which was traditionally the case), for the formation of leaders, therefore education has been limited. As Zespri moves forward it needs to consider how to get more involved in the education of grower-shareholders and the formation of potential leaders to effectively lead the company and remain grower-owned and grower-controlled.

Directors at Zespri receive further training once they become elected. All elected Directors go to the New Zealand Institute of Directors, where they attend a Directors Course, which is an intensive one-week course covering governance and company practice theory among others.

In terms of the up-skilling of potential Directors or leaders, Zespri sponsor growers to the Kellogs Leadership course at Lincoln University in New Zealand. Zespri has sent a few selected growers over the last years to the program and already among the Board two Directors come from that course.

With respect to the education and up-skilling of growers, Zespri concentrates strongly on the technical up-skilling of its grower base. Among the various technical up-skilling mechanisms used by Zespri are: Zespri Innovation Seminars, Tech Transfer meetings, ZESPRI™ Gold kiwifruit field days and the Zespri Innovation Forum, which is particularly interesting. The two-days Forum consists of presentations and workshops where Zespri Innovation current and

future research is presented, including fruit quality improvement, growing methods, orchard and packhouses best practices, and pest and disease control.

The second aspect of education, related to the company's functioning, occurs at Zespri mainly through informal mechanisms and through most of the already mentioned communication mechanisms like Roadshows, Kiwiflier, the Kiwifruit Journal, grower website, 'under the vine' meetings and others, which also work as education mechanisms that raise the level of knowledge and understanding of the growers and shareholders.

In 2001 Zespri launched the Industry Plan process which included the elaboration and sending (in October 2001) to all growers of a very comprehensive document of 228 pages, Zespri's Workbook, which provided information related to the global marketplace, trends for the future and summarised Zespri's strategies to face those challenges. The document/book represents a high-calibre educative tool.

"Some growers expressed amazement that we would trust them with such detailed information about our customers and competitors. This is a genuine attempt to break down barriers between Zespri and its producers" (Doug Voss, Zespri Executive Chairman, The Orchardist Magazine, November 2001, p. 40).

Together with the handling of Zespri's Workbook, the company held 38 meetings with growers, attracting a total of 900 growers. The meetings aimed to discuss the issues raised in the Workbook like the company's performance measuring, grower relationships and how to improve communication between growers and Zespri among others.

Finally, as a response to the existing shortage of production and management people available to the kiwifruit industry, Zespri, together with KGI and fruit Grower associations have started the KGI Cadet Training System. The objective of the Training System is to attract people to all facets of the kiwifruit industry: running orchards, owning orchards, working on orchards, post harvest operators, suppliers and for Zespri.

5.8 Implications of the internationalisation strategy adopted

5.8.1 Advantages

The advantages that a co-operative-type company like Zespri can gain from internationalisation are almost the same as those that apply for IOFs, including continued growth, achievement of economies of scale and scope, strengthening of competitiveness, utilisation of know-how, access to bigger markets and ability to seek resources abroad (Federation of Danish Cooperatives, 2000; Buccola et al. 2001). In the case of Zespri, some of these advantages are even more obvious, due to the strong seasonality of kiwifruit production.

Even though it is not the objective of this project to analyse in depth the advantages of internationalisation, some of the advantages for Zespri and its growers-shareholders of the adopted internationalisation strategy are analysed below:

(I) Strengthening of retail and customer relationships

Supermarkets are increasingly looking to be supplied by fewer and larger suppliers on a year-round basis, the risks of not responding to this challenge could be fatal: *“Failure to listen to supermarkets pleas for fruit to be supplied all year round could see them filling their needs from other sources”* (Tony Marks, Zespri CEO, Orchardist Magazine, March 2001, p. 42).

By supplying kiwifruit on a year-round basis, Zespri would be able to strengthen its relationship with supermarkets and retailers, eventually becoming a Kiwifruit Category Manager in selected supermarket chains, increasing its market share and therefore its revenues.

(II) Maximisation of assets and infrastructure (minimising costs)

New Zealand kiwifruit growers can only supply six to eight months a year, being out of the market for four months (from January to April) and in the case of ZESPRI™ Gold kiwifruit

they are out six months. In other words, currently Zespri has an 8-month business with an infrastructure (onshore and offshore) that is running 12 months.

Therefore, by marketing externally sourced kiwifruit (contracted Green kiwifruit and licensed ZESPRI™ Gold kiwifruit) in the New Zealand-off season, Zespri is able to commercialise complementary product through the existing channels generating extra revenues with (in general terms) the same fixed costs and as a consequence of this, the unitary cost of New Zealand kiwifruit decreases. Also, there are other operational costs that would also eventually drop as Zespri successfully implements its year-round marketing plan, like for example the costs of re-listing every year with the major retailers and associate costs of re-launching the brand every year to refresh it in the customer's mind.

(III) Maximisation of assets and capabilities

Zespri has certain firm-specific capabilities, namely marketing, supply management, R&D (variety ownership) and brand power. At the moment Zespri is strictly utilising its capabilities in New Zealand. The exploitation of these capabilities across a wide range of markets has the potential to significantly increase returns without increasing costs.

By internationalising its ZESPRI™ System, the company's capabilities would be optimised, R&D would be used more effectively and advertising and promotion spent more efficiently. This last point is extremely important; for Zespri, being a brand marketer, the best way of getting exposure to its brand (and pay back the brand investment), is to actually have it consistently in front of the consumer/customer, for twelve months of the year.

(IV) Access to key resources

In the case of Zespri the first key resource to which the company gets access by internationalising is kiwifruit, which results complementary to the one produced by its grower-shareholders in New Zealand. By doing this the company will increase its market share (currently at about 25%) with the obvious benefits. The complementary production is

likely to be sourced mainly from Northern hemisphere countries like Italy, the US, France, Iran and Japan.

Zespri will be also in the position of sourcing kiwifruit from Southern hemisphere countries although in limited quantities and periods. For example, by licensing and growing ZESPRI™ Gold kiwifruit in Chile, Zespri could probably gain six weeks in the market, without clashing with the last of its ZESPRI™ Gold kiwifruit being produced in California and the first of its ZESPRI™ Gold kiwifruit of New Zealand origin. Currently the company has a small experimental orchard in Chile.

In certain seasons Zespri could even source offshore kiwifruit from other words from southern hemisphere countries simultaneously to New Zealand supplier-shareholders' production, if demand surpasses supply and there is an economic case for the benefit of both, the company and growers-shareholders: *"Zespri international has been increasing demand for its product but has been hampered by reduced crops for the past 2 years. [The past two seasons] We have not been able to supply the full needs of all our customers and that is very difficult"* (Doug Voss, Chairman of the Board, Orchardist Magazine, March 2000, p. 37).

The other face of the year-round marketing strategy is that in the future Zespri could eventually import offshore kiwifruit to New Zealand when the locally produced crop is unavailable. Even though New Zealand, with a population of about 3.8 million does not represents a big market, it is still an attractive market with a high consumption rate of kiwifruit. By doing this the company would be increasing revenues and serving its home market.

Although a key one, kiwifruit is not the only resource that Zespri could eventually secure through internationalisation. At this stage the strategy is in its infancy, but as numbers and the commitment degree increase, Zespri could secure other key resources like key labour and marketing skills (people) and technologies.

(V) Financing and capital structure advantages

By separating the dividend from the fruit payout, Zespri has unbundled growing fruit revenue from shareholding revenue. It is so, easier for grower-shareholders to measure the company's performance at both levels. Also, by having fully tradeable shares (between growers), Zespri allows growers to reflect their proprietorship in the company and any international venture according to their risk preferences. In other words, individual growers invest in shares of Zespri Group Ltd. and even Kiwifruit International according to their individual financial position, risk profile, etc.

Finally, as the company's internationalisation process progresses and the share dividend increases, there could be long-term capital benefits for grower-shareholders, given the cooperative mentality and as growers sell and buy orchards with shares.

VI) Risk reduction and diversification

By investing offshore, Zespri has to a certain extent reduced risks to both the company and its grower-shareholders. In situations of, for example, climatic catastrophes the company would be in a better position if it was sourcing from several geographic areas rather than from only one country.

In this situation, if the New Zealand fruit season was negatively affected by external factors (hail, pests, etc), grower-shareholders would eventually receive an independent income. At this stage the share-dividend revenues are minimum in relation to the fruit revenues, but as the company grows internationally these could significantly increase and at some stage become a significant part of grower-shareholders' returns.

Also by diversifying from being exclusively an exporter of fresh fruit into getting involved in value-added processing (Aragorn Ltd.), Zespri is diversifying (although in a limited way) its sources of revenues.

The possibility of marketing other horticultural products on a global scale, also stand out as an attractive diversification alternative.

VII) Global scanning and learning (access to knowledge)

The ability to learn from international exposure and opportunities through its network of subsidiaries and business relationships is one of the greatest advantages that any company can gain from internationalisation (Bartlett & Ghoshal, 2000). Although Zespri is only recently internationalising (beyond its history as exporter) and it operates in an industry where margins are small and where innovations are easily duplicated, limiting major R&D investments, Bartlett and Ghoshal's concept still applies.

5.8.2 Risks and potential conflicts

(I) Failure in offshore ventures

The first and most obvious risk of an internationalisation strategy for Zespri is to fail in its offshore ventures. Zespri has been facing difficulties in implementing its year-round marketing strategy, as its offshore ventures have not been profitable yet. In the season 2001/2002 the company experienced a \$160,000 loss from trading overseas grown kiwifruit in the New Zealand off-season, mainly due to a big drop in the Italian crop, according to the company.

In Zespri, New Zealand grower-shareholders are effectively protected from offshore losses, because of current legislation and company structure, and losses are underwritten by Kiwifruit International. Still, Zespri must learn quickly and turn those numbers into positives and start delivering bigger profits to its shareholders.

Zespri is facing new challenges offshore. As the company is starting to operate in the Northern hemisphere's winter it will be now competing with local kiwifruit marketers as well as other winter fruits (e.g. citrus). Zespri will have to better understand the Italian, French and American kiwifruit industries, including their supply chain and post harvest operations. The company will be facing conditions that are different to those in New Zealand. To date, Zespri

has proved to be the best kiwifruit marketer in the world (Belrose, 2002), and will now have to adapt itself to local differences.

(II) Brand damage

In an industry like fresh produce, where the variability of product is large, the risks of damaging and depreciating the brand are considerable. For a branded marketer like Zespri, which has a recognised brand, the risks (as well as the opportunities) are higher. By marketing fruit sourced from offshore suppliers, both ZESPRI™ Green and ZESPRI™ Gold kiwifruit, Zespri is facing a risk that must be managed carefully.

When marketing product of a different country of origin under the same brand, the company must ensure a consistent price and quality policy. Zespri must ensure that the product it is externally sourcing is up to the required specifications, that is to Zespri standards.

In order to internationalise its quality standards, protecting its brand from potential damage Zespri has developed the roles of International Supply Manager, responsible for establishing plantings and operational systems offshore; Quality Overlay Manager, responsible for implementing Zespri standards offshore; and Technical Transfer Overlay Manager responsible for transferring the ZESPRI™ System intellectual property offshore. Therefore it can be said that as Zespri will not be buying kiwifruit to fill shortfalls on the spot market, but instead the company is entering into contractual agreements with established offshore growers who are receiving training and the fruit will have pass through Zespri's quality standard controls, the risk is being managed.

(III) Real or perceived competition between overseas Zespri product and New Zealand Zespri product

In general terms Southern and Northern hemisphere's kiwifruit productions are complementary, as when New Zealand kiwifruit gets to the markets, the Northern hemisphere kiwifruit is almost totally finished. Similarly, the New Zealand fruit is generally finished by the time the Northern hemisphere fruit is entering the market. Therefore in terms of marketing complementary fruit from Northern hemisphere countries (e.g. Italy, US), Zespri should be able to manage the marketing without overlaps of production that could generate competition problems.

Although the previously described situation is the most likely to happen, Zespri, and its grower-shareholders must be aware that due to the variability of fruit production, overlaps of production when sourcing from different countries is a possibility and that frictions can arise as a consequence. Having said this, it must also be acknowledged that in the theoretical situation of production overlaps, Zespri would be in a more convenient position to manage prices if sourcing from different countries.

If Zespri complements its New Zealand production with fruit sourced from Southern hemisphere countries (e.g. Chile) it could face some difficulties as windows of production are less clear and overlapping is more likely to happen, although they should also be manageable, as long as the company has the appropriate systems in place.

In all situations timing will be critical, as Zespri must ensure that it finishes the onshore fruit (New Zealand) in time before starting with the offshore fruit (e.g. Italian) and vice-versa. The balance that the company must meet in terms of its primary responsibility with its New Zealand grower-shareholders and its responsibility with the new offshore suppliers is not an easy challenge.

“As we go forward, while we have to build relationships with alternative suppliers [e.g. Italians] to be in that business and we have to have loyalty to those other suppliers, we cannot let that loyalty to those other suppliers override our responsibility to the New Zealand growers” (Craig Greenlees, Director of the Board, personal interview, September 2002).

While it can be argued that if the company is successful in selling externally sourced kiwifruit, even if there is a slight overlapping of production, grower-shareholder would be receiving the benefit through the share dividend, the reality is that the dividend income is likely to be significantly smaller than the fruit income (fruit payout). If over time the dividend income increases, becoming a significant share of grower-shareholders' returns, the argument could be stronger and concerns about competition less frequent; currently this dividend is 7 cents compared with fruit revenues of \$7-10 per tray.

The existence of non-shareholders within the New Zealand grower base means that those growers could get affected by competition from externally sourced kiwifruit production overlaps, but unlike grower-shareholders they would not receive benefits through the dividend, therefore the existence of shareholders and non-shareholders has serious implications for the internationalisation of Zespri.

(IV) Real or perceived deficient service to supplier-shareholders

Zespri cannot be perceived (regardless of its accuracy) by its grower-shareholders to be locating more attention and resources to its offshore ventures and new suppliers and partners than towards them. This issue although simple in theory, will be a key factor as the company's offshore involvement increases.

Zespri must pay special attention to maintain and improve where possible, its service to its grower-shareholders in New Zealand while following a strategy of growing internationally. Also, as the company starts to have a supply base not only in New Zealand but also in different countries overseas, there is the risk that the special relationship with its original grower-supplier could be somehow eroded, as the company becomes less dependent on one supply base.

In an eventual deregulated environment, besides fruit payout, the company will be evaluated by its service level, in other words by all the complementary services the company gives to its grower-shareholders. If service levels are not considered satisfactory, the company runs the

risk of losing suppliers in New Zealand or even seeing its New Zealand single exporter status removed.

(V) Company/growers distancing (disenfranchising)

Zespri, as any company, faces the challenge of remaining close to its supplier base while growing and expanding, as the organisation gets bigger and the communication lines are diluted. There are several possible causes for growers' distancing themselves, including company size, company structure and lack of understanding from growers of the company's strategy. In Zespri's case, supply structure probably plays a much more important role than any of the other mentioned factors over the growers feeling of distancing: "*Many growers have a perception of increased distance between themselves and Zespri and are unsure where the average grower fits into this new supply structure*" (Zespri Workbook 2001, p.11). Therefore structure and the other factors identified as potential causes for the distancing between growers and company are analysed below.

Before proceeding with the analysis, it must be stated that the distancing of its grower base is something the company is already facing regardless of its internationalisation strategy. The words of two elected Directors in July 2001 give an indication of this distancing Zespri has been experiencing from its grower-shareholders. Alan Sutherland, just after being elected Directors, declared that one of the reasons he sought election was that he was unhappy with the state of the interface between Zespri and growers suggesting that "*if the Board had not got out of touch with electors he would not have been elected*" (Orchardist Magazine, September 2001, p.46).

"Zespri is doing a very good job as a marketing organisation, but we have distanced ourselves from shareholders. We need to put in place systems and relationships that will strengthen the bond. The lack of understanding cuts both ways" (Graham Cathie, Orchardist Magazine, September 2001, p. 46).

The improvement of the grower/Zespri interface has been identified by the company as a priority and the influence of the current supply structure in their distancing has been admitted as significant.

The current supply structure means that Zespri deals with suppliers (there are twelve suppliers), with supplying-packhouses being below them and then finally growers at the base of the pyramid, although some growers contract directly with suppliers. Therefore, growers are either two or three stages away from Zespri for operational as well as financial issues. The structure, although it has some efficiency benefits, has been identified as a source of concern, especially for growers who feel disconnected from Zespri. In addition, the information flow along the Zespri-supplier-growers chain has not been uniform among the different suppliers, therefore creating further discontent among certain growers and even among certain suppliers. Finally, the fact that some of the suppliers have a co-operative-type structure and some are of a corporate structure, make some growers feel even more distanced from the company they own, Zespri. Due to the reasons mentioned above, the whole supply structure, including the interaction of Zespri with growers and with suppliers, is currently under review.

A significant portion of the grower base including KGI have manifested their belief that Zespri should re-establish its commercial relationship with growers leaving suppliers as service providers to be contracted out by growers:

“I believe Zespri should be dealing directly with grower shareholders rather than the supplier entities. We are getting into a dangerous situation where growers cannot deal directly with Zespri” (Graham Cathie, Director of the Board, Orchardist Magazine, September 2001, p.46).

“I believe money should go to growers, and the relationship with suppliers and post-harvest operators should be only of service providers; and I believe that it was a mistake to give suppliers control over the money” (Grant Eynon, KGI Chairman, personal interview, August 2002).

In direct response to growers' concerns of being disconnected from Zespri, the company established in 2001 the Grower Liaison Manager position. Currently Zespri has two Grower

Liaison Managers whose function is to work as a two-way communication structure: downwards they present latest operational information and market summaries and clarify existing doubts to growers; upwards they listen to feedback from growers on topical issues. Also the company's headquarters move from Auckland to Bay of Plenty can be understood as a clear signal of Zespri intentions of getting closer to its grower-shareholders. These measures, although effective, do not address what seems to be the major reason of the growers' distancing feeling: the supply structure.

In terms of other reasons that can be identified for the distancing of growers from Zespri, factors like company size, governors/growers distancing and the lack of understanding of the company's strategy can be mentioned.

Zespri has about 2,500 growers, most of them concentrated in the Bay of Plenty region, the size although not small can still be considered manageable. Zespri is governed by an eight-member Board, five of them being grower-elected Directors (also known as industry Directors), that equate to a representation of one Director for every 310 grower-shareholders. If only grower-elected Directors are considered, as they have a closer relationship with growers, equates to a representation of one Director for every 500 members; still manageable. In terms of the Zespri CEO's interaction with growers, being involved in four Roadshows per year where the strategy and the company's operational performance is presented to grower-shareholders, the relationship, is arguably closer than many pure co-operatives and IOF companies. Therefore at least in theory the interaction (or lack of interaction) between growers and governors should not be a source of distancing for Zespri.

In terms of the potential lack of understanding of the company's strategy, although this is a possibility, the company has actively communicated (through Roadshows and other communication channels) the business case behind year round marketing. As the strategy and its implications are relatively simple in this first phase, this can also be discarded as a major reason for the distancing of growers. Still, further communication and education will likely be necessary as the internationalisation process of the company progress, in order to maintain shareholders close.

Also, as the company has grown, the supplier base has become more fragmented, with growers product groups emerging (Gold, Organic and Green) each of them with slightly different interests.

The challenge for Zespri is how best to communicate and what channels to use, in order to minimise the disadvantages of the current supply structure, while at the same time maintain the efficiency advantages of dealing with just 12 suppliers instead of 2,500 growers. In terms of the channels, although electronic channels would probably be the most efficient way, the amount of growers connected is limited (12%). The use of several printed mechanisms, the 2001 Industry Workbook and the company's Roadshows are all proof of the significant efforts the company is making to keep its growers informed and at the same time elevate their level of understanding of the business.

(VI) Governance potential conflicts

Zespri is heading towards becoming a billion dollar company. Increasingly, its international businesses will become more complicated. Zespri needs grower-Directors capable of managing this increasingly complex business as well as external expertise in those areas that are not in grower-Directors' backgrounds.

As elected-Directors also have to be elected (confirmed) by grower-shareholders, Zespri runs the risks of losing valuable external inputs and becoming totally subject to growers' moods, running also the risk of having good politicians rather than good Directors on its Board. This issue goes totally against the logic of having a mixed Board of Directors, where elected and appointed Directors' skills should be complementary.

Also related to Directors, the company has traditionally relied on the arrival of talented people from other industries and from a range of backgrounds for the formation of leaders (i.e. Directors). In the future Zespri will probably need to invest more heavily in education in order to have a qualified grower base from where capable Directors will arise, if not, the company runs the risk of having ill-prepared Boards, as the kiwifruit industry may currently not be as attractive for newcomers as it used to be.

(VII) Generation of conflicts between different categories of shareholders within the company

One of the most critical conflicts that Zespri will inevitably face as the internationalisation of its business continues is related to the existence of growers-shareholders, non-shareholders and low-shareholders (growers with a low shareholding in the company in relation to their production levels) within Zespri's grower base: *"Because we have created a system where suppliers and shareholders are not necessarily one of the same, we have created potential problems"* (Terry Richards, former KGI president, Kiwifruit Journal, March 2000, p.4).

In terms of the implications of this issue over the company's internationalisation, Zespri will face obvious conflicts of interest when representing both growers and shareholders, because while marketing externally sourced fruit, Zespri will be clearly benefiting Zespri shareholders, but it may be disadvantaging non-shareholders.

Even though it can be argued that the existence of non-shareholders within the company is a result of certain growers own choice to not participate in the business and therefore Zespri's responsibility to them is minimal, the fact is that Zespri will be incrementally facing difficulties in terms of grower support if the interests of these different categories of growers get distanced or the percentage of non-shareholders and low-shareholders increase. Under current conditions the logic would be for this differentiation to increase, as growers will be attracted to not sell their shares when retiring as returns from shares become stronger and they have no obligation to sell them.

Although probably this issue does not represent an immediate conflict of magnitude for Zespri, as currently about 90% of growers have a degree of shareholding in the company and the volumes of externally sourced kiwifruit are insignificant, the company must be careful about how it moves forward.

(VIII) Financing conflicts

Following growers' concerns, at the end of year 2000 the company changed its voting system for growers to retain total control of the company. Later on, in February 2001 the company issued a capital raise, which was only partly subscribed (61%) by growers. Therefore it can be said that the company is constrained in terms of its financial freedom for venturing into new business opportunities.

In order to understand the negative effects (although in an extreme situation) that the combination of financial constraints and internationalisation lead to in a co-operative –type firm, it is useful to revisit the experience of the French dairy co-operative, ULN (Mauget & Declerck, 1996). In the early 90's ULN followed an aggressive expansion strategy acquiring companies in Belgium, Spain and the U.S. ULN's strategy turned into a disaster when the co-operative did not succeed in getting the necessary capital from its members, it had to borrow from banks and by 1992 when bankers refused to renegotiate the debt, a holding formed by bankers and French corporate dairy firm Bongrain acquired ULN's processing units. The co-operative ended up managing only milk collection.

After the company's partial failure in raising capital, an unhappy Chairman of the Board stated: "*Growers should be under no illusion that if required support does not materialise, we will have to find capital elsewhere...we will have no option but to explore different sources of capital*" (Doug Voss, Executive Chairman, Kiwiflier, March 2001, p.1).

Almost two years have passed since the chairman's declarations, but Zespri has not explored alternative sources of capital so far. Instead, and after three very profitable seasons, Zespri has been able to lift its capital base (equity), by just retaining earnings close to the \$22 million level. The number, although situates the company in a better position for covering its operational costs against banks⁶⁰, restricts it for eventual offshore projects. Having said that, it can be argued that the financial restrictions Zespri have faced so far have been more theoretical than real as the company has not targeted any major project that could demand substantial investment.

⁶⁰ Zespri annually borrows about \$150 million from banks to finance the crop.

The reasons for the failure of the 2001 capital raising can be found in different streams such as timing, growers' risk-aversion, inefficient communication, etc: *"While the original (share) issuing was not a roaring success, I think it was because that was a company that didn't have a track record in terms of profitability -that was Zespri then-. Today Zespri has moved on, showing that it can be profitable, continuing to perform in the market place for the growers and if we have a good reason for raising capital and the growers share that view, I am sure the growers would look at putting more capital with Zespri in the future"* (Craig Greenlees, Director of the Board, personal interview, September 2002).

Zespri's intention is to become a 12-month marketer, but in order to fulfil its ambition, additional capital will be necessary: *"We need to attract more investment offshore in planting and growing ZESPRI™ Gold kiwifruit. We need to meet our customers' expectations of continuous supply so we need to push very, very hard to get this variety moving strongly"* (Tony Marks, CEO Zespri, personal interview, July 2002).

As Zespri grows offshore it is likely that the company will test the boundaries of developing venture capital which will come either from the grower base by, for example, new shares issuing or from external sources like JV partners, market capital, bonds, etc. The key trade off between the internal and the external sources will be capital versus control dilution.

It is also worth of mentioning that as Zespri has no independent sources of capital, the existence of internal product groups within the company puts Zespri in an uncomfortable situation. Concerns of cross-subsidisation and general tensions between groups is a reality that Zespri has to deal with and has imposed further financial constraints over the company as product groups have been reluctant to fund activities that could benefit other groups.

(IX) Conflicts associated with the internationalisation of knowledge and capabilities

Zespri is starting to internationalise its knowledge and capabilities in two ways: firstly, through on-ground support in Italy and the United States to help licensed ZESPRI™ Gold growers produce the volume and quality of fruit required, as well as assisting offshore

growers in the external procurement of ZESPRI™ Green kiwifruit to brand specifications, and secondly by licensing its owned variety ZESPRI™ Gold kiwifruit.

As already stated, as Zespri wants to succeed offshore and protect its brand from potential damage, the company is internationalising more than its brand, it is also internationalising its post-harvest knowledge, its quality systems, its marketing knowledge and its ZESPRI™ System, what can be called its core capability. The obvious risks of this strategy are related to the transfer of aspects of the ZESPRI™ System to potential supply competitors.

As certain technologies are not the exclusive property of Zespri or property rights are extremely difficult to implement, it is probably only a matter of time before competitors get the information. The challenge for Zespri, as for any company leveraging its knowledge worldwide, lies in continuous innovation and maybe protecting its grower-shareholders by establishing a one or two year delay in the technology release.

On the other hand Zespri is also internationalising knowledge by licensing its ZESPRI™ Gold variety to offshore growers. Although the company has the variety rights of ZESPRI™ Gold kiwifruit, the risks of illegal replications in the fresh produce industry are higher than in other industries:

“I think the New Zealand growers recognize that if you happen to develop an internationally successful product in a country A, it will ultimately migrate to country B and C. In fact Hayward kiwifruit happily growing in Chile, Italy, France, Portugal, Korea, Japan etc. is a walking case study. So I think that from that point of view, we need to guard the internationalisation of Gold through controlling the PVRs [plant variety rights], the plantings and the marketing, thus minimising the risks” (Tony Marks, CEO, personal interview, July 2002).

Although variety rights protection legal length is of 20 years, the common belief is that the company has a period of about 10 years after which variety rights become less tough. For Zespri the real challenge is to protect the variety in its early years and establish significant volumes of ZESPRI™ Gold kiwifruit marketed under its system. In that way after variety

rights expire (legally or practically) the company will have commercial control of the variety in terms of the volumes, brands, distribution channels and relationships with customers.

(X) Corporate/co-operative conflict

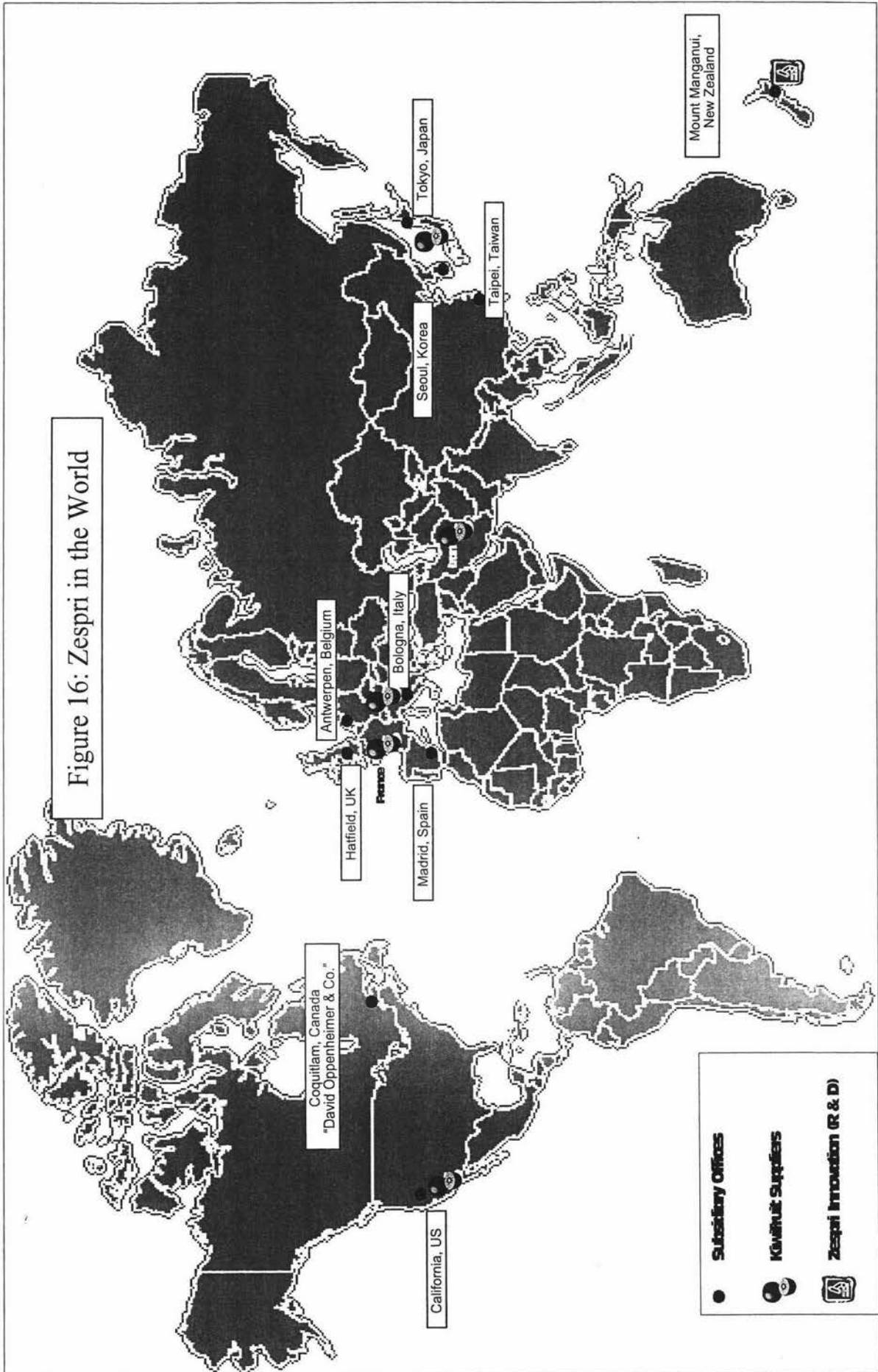
Due to Zespri's unique business structure the company can find itself in situations where its corporate and its co-operative natures conflict. Zespri as a company has been learning over the past years the implications (positive and negative) of being a co-operative hybrid.

It is important for Zespri as it goes forward in its internationalisation process to continuously remind its Directors, elected and appointed, and especially its executive management staff, the differences between this co-operative hybrid structure and a traditional IOF, as well as the implications of all strategic initiatives the company takes offshore over Zespri's grower-shareholders in New Zealand.

On the other hand, it is also important to continuously clarify among its shareholder base that Zespri is not a traditional co-operative, but neither is it an IOF in terms of the benefits of being a shareholder of Zespri: *"I still think that shareholders haven't come to the fact that they are the owners of the business in reality as well as conceptually. I think as growers realise the value of being a shareholder, the value of the business, I think they will become closer to the business"* (Doug Voss, Executive Chairman, personal interview, September 2002).

In terms of its international businesses Zespri has obligations with its growers and with its shareholders, which in the majority of the cases are the same people, but not always, and this is something the company must be extremely aware of as it navigates into the future.

Figure 16: Zespri in the World



CHAPTER SIX: CROSS CASE ANALYSIS

In order to determine significant similarities and differences between the two studied co-operatives, a comparative analysis following Yin's (1994) pattern matching technique is undertaken below. The comparison starts with general similarities and differences, their internationalisation process, and the risks and potential conflicts faced by these two co-operatives in relation to internationalisation.

Following this, the critical factors for the internationalisation of agricultural co-operatives are identified and analysed, comparing the structures and mechanisms used by the two studied co-operatives with the theory and specialised literature. Considering that case studies are not completed until their outset and that even their design can be revisited after the initial stages (Yin, 1994), the analysis of the critical factors includes both literature identified in the literature review chapter as well as new relevant literature identified subsequently.

6.1 Comparative analysis: Fonterra and Zespri

Fonterra and Zespri are extremely different co-operatives and therefore extrapolations to co-operatives in general and even from one to the other are hard to make. When doing a study about co-operatives, Buccola et al. (2001, p.123) stated: "*We are impressed with the difficulty of making generalisations about co-operatives international sales arrangements. The heterogeneity of firm size, financial structure, product mix, processing extent, geographic market and sales arrangements in our sample is so great that any effort to rationalize them all inevitably collides with model and data deficiencies*". Having said this, after reviewing both case studies significant similarities arose, which allow some interesting conclusions to be made.

6.1.1 General similarities and differences

The main similarities between Fonterra and Zespri are:

- Both are co-operative companies: producer-owned, producer-controlled, and producer-benefited.
- Both are New Zealand companies and therefore operate in an un-subsidised environment.
- Both companies evolved from being national producer Boards, Fonterra from the New Zealand Dairy Board (NZDB) and Zespri from the New Zealand Kiwifruit Marketing Board (NZKMB).
- Both companies have a similar investment in R&D of about 0.6-0.7% of total revenues, which is undertaken by R&D business units, the Fonterra Research Centre and Zespri Innovation respectively.
- Both companies can be considered leaders in their industry, Fonterra is the world's fourth largest dairy company (having the largest R&D dairy-specialised centre) and Zespri is the world's largest kiwifruit marketer.
- Both companies concentrate on servicing foreign markets with Zespri exporting 99% of its production and Fonterra 95% of it. Also, both companies are externally sourcing product to complement their New Zealand supplier-shareholders' production, with offshore production.
- Their brand strategy can be considered similar, in terms of the selection of corporate brands (Fonterra and Zespri) with no cultural or geographical delimitations, de-linked from their New Zealand origin in order to be able to internationally leverage the brands.
- Some of the risks and potential conflicts the two companies are facing while internationalising are similar as will be analysed below.

The main differences between Fonterra and Zespri are significant and include:

- Fonterra is a pure co-operative, while Zespri is a co-operative hybrid.
- Fonterra is a dairy company and Zespri is exclusively a kiwifruit marketer. Also, as the kiwifruit (fresh fruit) and the dairy industries are different, the marketing strategies these two companies use are different.
- Their sale volumes are different, so while Fonterra is New Zealand's largest company with revenues in 2001-2002 of NZ\$13.9 billion, Zespri's revenues in the same season were NZ\$800 million.
- The difference in the size of both organisations is also remarkable, with Fonterra having a staff of about 20,000 people and Zespri 184.
- The two companies have significantly different equities that situate them in different position for undertaking international growth. Zespri has an equity of NZ\$22 million compared with Fonterra's NZ\$4.5 billion. In terms of their equity ratios (equity/assets), for Fonterra this is 38% and for Zespri 28%.
- Their number of shareholders and geographic distribution are also different: Fonterra is owned by over 13,000 farmer-shareholders distributed across New Zealand; Zespri is owned by about 2,500 grower-shareholders mainly concentrated in the Bay of Plenty region (North Island).
- Fonterra as a dairy company follows a multiple sequence strategy, covering a diverse range of products that in general terms consist of four broad groups of products. Zespri is a kiwifruit marketer, in general terms a one-product company.
- Beside its core business, Fonterra also has subsidiaries in the biosciences industry (ViaLactia), the farm retail industry (RD1) and Internet services (fencepost.com). Zespri, although lowly starting to get involved in value-added businesses (Aragorn Ltd.), is a company 99% focused in the fresh kiwifruit business.
- In terms of brand strategy comparison although both companies are branded marketers, their approach is different. For Zespri their corporate brand is used for all its products (e.g. ZESPRI™ Green kiwifruit), the licensing of its ZESPRI™ Gold kiwifruit, and even for its management systems (ZESPRI™ System). In Fonterra's case, although the company has an extensive brand portfolio, that includes own (e.g. ANCHOR™, ANLENE™, MAINLAND™, TIP TOP™, CHESDALE™,

SOPROLE™ and others) and partner's brands (e.g. Nestlé and Arla Foods), its corporate brand (Fonterra) is not used as a consumer brand.

6.1.2 Internationalisation process

Internationalisation, starting from its simplest form (exporting), can be considered to be the only feasible strategic alternative for most agricultural co-operatives in New Zealand, because of the limited size of the domestic market (3.8 million). For Fonterra and Zespri this is definitively true as both co-operatives are focused on serving foreign markets and their exporting nature can be tracked back to their origins as export-driven Producer Boards. Something that has already been mentioned but is worthy of repeating is that because both companies are concentrated on servicing foreign markets with Fonterra exporting 95% and Zespri 99% of their production, the New Zealand dollar exchange rate has a huge impact over both companies' performance and their supplier-shareholders payout. Therefore both companies have cover mechanisms in order to minimise that impact.

Following Bartlett and Ghoshal's (2000) classification system, it can be said that Fonterra is a truly multinational company with over 90 subsidiaries and associated companies worldwide, following in general terms a multinational strategy, with some characteristics of a transnational company, like its global R&D network. Zespri instead can be classified as a company following an international strategy (i.e. exporting company) with the manifested intention of eventually becoming a global company, in terms of the replication of its ZESPRI™ System offshore.

Using the co-operatives' internationalisation model developed in this study it can be seen that Fonterra is involved in five out of the six modes/stages of internationalisation from simple exporting to the formation of alliances. In addition to the world-reaching network of companies that Fonterra inherited from the NZDB, the company has continued an aggressive programme of acquisitions and Joint Ventures with other dairy and food businesses in Europe, the Americas, Asia and Australia over the first twelve months of the company's existence. Besides the mentioned JVs and acquisitions Fonterra is also entering into new FMSMs like

the strategic alliance signed in 2002 with Nestlé in the Americas (North, Central and South America).

Zespri on the other hand, is involved in four out of the six FMSM: export, FDI, external sourcing and knowledge agreements. The first two have been the ones traditionally used by Zespri (and previously by the NZKMB) and only in recent years has Zespri slowly started to externally source product and to license its ZESPRI™ Gold kiwifruit variety. So it can be said that Zespri is in the early stages of internationalisation, using mainly exports and FDI (marketing subsidiaries) to serve foreign markets, and slowly moving towards more advanced FMSMs like external sourcing and knowledge agreements (licensing). One important factor in this respect is that Zespri’s thin capital base represents a limitation (at least theoretically) for the company to undertake JVs and acquisitions, therefore it has concentrated on exporting, and lately on establishing small-scale partnerships (license agreements and marketing contracts) with growers in Italy, the US, France and other countries.

Table 23: Summary of FMSMs used by Fonterra and Zespri

	Fonterra Co-operative Group	Zespri Group Limited
Export	Exporting is still Fonterra’s main FMSM. US: largest export market (>US\$500 million), Japan, second (US\$330 million) Top 8 export markets in the Pacific span	By far Zespri’s main FMSM, most of the volume is handled through subsidiary offices (qualifies as FDI) Japan is its largest export market and Europe its largest export region
FDI	Over 90 subsidiaries and associated companies worldwide; significant quantity of JVs During 2001-2002 Fonterra signed: 25:75 JV with Arla Foods in the UK ; 50:50 JV with Britannia Industries (India) 50:50 JV with Dairy Farmers of America; acquisitions of cheese and spreads businesses in Mexico;	Two big marketing subsidiaries: (1) Zespri Europe, based in Belgium with subsidiaries in France, Spain, Italy and the UK. (2) Zespri Asia Pacific, based in Japan with subsidiaries in Korea, Taiwan and the US. Minority equity interest (15%) in David Oppenheimer & Co. (North American fruit trading company)
External sourcing	Fonterra has 35 manufacturing plants outside of New Zealand, which receive and process milk externally sourced Export agreement with Dairy America, to export SMP from the US on commission	Complementation of NZ fruit with Italian, French and US kiwifruit (potentially from Chile) Difficulties in implementing due to quality and volume problems
Knowledge agreements	Not frequently used by Fonterra, still some examples can be found.	Licensing and distribution of ZESPRI™ Gold kiwifruit offshore; by 2002 there

	DR10™, commercially launched as Fernleaf Defense™, and then licensed to Danisco.	are about 700 hectares of ZESPRI™ Gold kiwifruit growing offshore (Italy, California, France and Japan) Offshore licensing is moving slower than expected (currently a third part of target)
Strategic alliances	Fonterra/Nestlé alliance (Dairy Partners Americas) will set up JVs in North, Central and South America. DPA will initially have a staff of 10,000 and an estimated first year turnover of US\$1.4 billion	No
Transnational co-operative	No, not part of current strategy Fonterra currently owns 25% of Bonlac co-operative in Australia Formation of AFHL in 2002 can become a key factor.	No, not part of current strategy Currently working closely with Italian and North American growers, providing technical assistance and training Currently Zespri has contractual agreements with four Italian coops for external sourcing of kiwifruit

Table 23 summarises Fonterra and Zespri's internationalisation situation in terms of the foreign markets service modes they use, according to the model developed in this study and as can be seen the differences are significant.

Both co-operatives have a long tradition of exporting, than in the case of Fonterra can be tracked back to 1860 and in the case of Zespri to 1960. In both cases, exporting is still their main FMSM and although their main export markets differ, for both co-operatives Japan and South East Asia have a tremendous importance. It can be said that in general terms Zespri has its export markets more concentrated than Fonterra.

As many co-operatives worldwide have been finding over the recent years, the external sourcing of product is a necessity co-operatives cannot overlook. Both Fonterra and Zespri (to a lesser extent) are involved in the sourcing of product from non-members. Fonterra has 35 processing plants around the world and Zespri is starting to source Hayward kiwifruit from selected growers mainly in Italy, France and the US.

Although both co-operatives are involved in knowledge agreements, Fonterra does not use these as important FMSMs, but because of its R&D capabilities, Fonterra has some licensed products. In Zespri instead, this FMSM is expected to become a significant source of revenues, because together with the licensing of new varieties (e.g. ZESPRI™ Gold kiwifruit), Zespri ensures itself the marketing of the product and the internationalisation of its ZESPRI™ System.

In general terms, it can be said that Fonterra is far more advanced in its internationalisation process than Zespri. The signing of the strategic alliance with Nestlé in the Americas is proof of that and a major step for the company. The logic behind strategic alliances lies in the complementarity of capabilities, in this case Fonterra's large-scale procurement and processing and Nestlé's marketing and branding capabilities.

In terms of the sixth stage of internationalisation, so far neither Fonterra nor Zespri, have manifested intentions of becoming transnational co-operatives by accepting offshore suppliers as shareholders. As already mentioned, the advantages in the establishment of transnational co-operatives are several from the strategic and financial point of view. On the other hand if eventually these companies decide to internationalise their shareholding, there are several barriers that both companies will have to overcome, with the cultural ones the most difficult.

At present, both companies are involved in business relationships with co-operatives offshore, Fonterra with Bonlac Foods in Australia⁶¹ and Zespri with four Italian co-operatives. Collaborative business relationship (JVs and alliances) with foreign co-operatives can be the first step of a process that could end up with the formation of a transnational co-operative, as was the case with the JV established between the Danish co-operative MD Foods with the Swedish co-operative Arla in the mid 1990's that led to the formation of the transnational co-operative Arla Foods in 2001.

If eventually these companies decide to accept overseas suppliers as shareholders, there are different alternative models than can be adopted rather than the fully integrated transnational

⁶¹ Beside its JV relationships with Arla Foods in the UK and DFA in the US.

co-operative, as this is often difficult to implement. In this respect it is interesting to note the model adopted by the Dutch flower co-operative Aalsmer. Besides having 'full members' in Holland (96%), Germany (1%) and Belgium (3%), Aalsmer has 'special suppliers', with some degree of influence (no voting rights) but full delivery obligations, in Israel, Kenya and Ecuador, and 'normal suppliers' in different parts of the world. Other models of gradual affiliation that exist in order to make the transition from national to transnational co-operative smoother include: (1) joint enterprise owned by co-operatives, (2) gradual convergence of two co-operatives; and (3) gradual affiliation of foreign members (Federation of Danish Co-operatives, 2000).

6.1.3 Risks and potential conflicts of the internationalisation strategy

Several co-operative researchers have identified the emergence of conflicts in modern co-operatives as they internationalise (In't Veld, 1996; Normark, 1996; Van Dijk, 1996; Salaberria, 1997; and USDA, 1997). The overcoming of these conflicts is a key factor if co-operatives want to succeed in the international markets.

Table 24 summarises the key risks and potential conflicts the two studied co-operatives, Fonterra and Zespri, face in their internationalisation process. The list includes general risks, the distancing of supplier-shareholders (identified as a key factor) and five broad areas where potential conflicts can be found: capital structure and financing, governance structure, knowledge internationalisation, selected FMSM and organisational structure. Although some of the identified risks are not exclusively associated with internationalisation and could be present in co-operatives as they grow in size, like for example, distancing and declining member commitment, they may be exacerbated with the process of internationalisation.

The general risks faced by these two co-operatives, and arguably by any company, in the process of internationalisation, are the possibility of failure of the foreign investments, the real or perceived competition of externally sourced production with supplier-shareholders production and finally the real or perceived deficient service to supplier-shareholders.

In terms of the real or perceived competition between shareholders' production and externally sourced product, these can be managed as long as the externally sourced production provides benefits in terms of: economies of scale and scope, reduction of seasonal variations and/or enrichment of product mix. Again, the sourcing of non-members product can lead to a different FMSM: the formation of a transnational co-operative. The Dutch potato starch co-operative Avebe is a good example of the previous point. To solve restrictions (quota production) of product in its local market, Avebe expanded its membership to 200 German potato growers. Also, to complement its core product (potato starch) Avebe started sourcing tapioca corn on a global basis.

The third of the 'general risks' identified for both Fonterra and Zespri in their internationalisation process is the perception (regardless of its accuracy) by its supplier-shareholders that the co-operative is locating more attention and resources to its offshore ventures and new suppliers and partners than towards them. This issue although simple to manage in theory, can become a critical factor as the company's offshore involvement increases. Just as happens in the international market place, where in order to win customers' preference and loyalty co-operatives must deliver a superior product, in order to win and retain members' loyalty, co-operatives must constantly deliver a superior service. The challenge for Fonterra and Zespri will be to maximise supplier-shareholders' benefits, both financial and service delivery, as these two can conflict in certain situations.

Table 24: Summary of risks and potential conflicts faced by Fonterra and Zespri in their internationalisation process

	Fonterra Co-operative Group	Zespri Group Limited
General risks	(I) Failure of foreign investments (II) Real or perceived competition of members' product with externally sourced product (III) Real or perceived deficient service to suppliers-shareholders	(I) Failure of foreign investments (II) Real or perceived competition of members' product with externally sourced product (III) Real or perceived deficient service to suppliers-shareholders
Distancing (disenfranchising)	(IV) Distancing of farmer-shareholders from the company	(IV) Distancing of grower-shareholders from the company
Governance Conflicts	(V) Directors' governing vs. representing conflict	(V) Directors' governing vs. representing conflict (to a lesser extent)
Capital structure and financing conflicts	(VI) Control dilution (VII) New entrants discouragement (VIII) Signal distortion	(VI) Generation of conflicts between shareholders and non-shareholders (VII) Financial restrictions
Knowledge internationalisation's conflicts and risks	(IX) Disadvantaging of NZ farmer-shareholders	(VIII) Disadvantaging of NZ grower-shareholders
Risks and conflicts associated with the selected FMSM	(X) Asymmetrical collaborative venture: <ul style="list-style-type: none"> • One partner more benefited than the other • Partner utilising newly acquired skills against the company in a geographic area outside of the venture's limits. 	(IX) Brand damage
Organisational structure	No	(X) Co-operative / corporate conflicts

Distancing and declining member commitment is a situation that many co-operatives worldwide have been experiencing and has been identified as a key risks in processes like internationalisation, and can be the result of several factors like a perceived lack of connection between member success and co-operative success, inability of the co-operative to differentiate itself from IOFs, co-operative size, as well as the previously mentioned 'general risks'. Whatever the causes, the integration of supplier-shareholders and co-operatives is a key factor for these last ones to succeed: "*Strong member commitment is typically a necessary ingredient for co-operative success*" (Fulton & Gibbins, 2000, p.9)

As Rabobank (2001a) stated, managers of co-operatives should try to avoid the following two possible routes: (1) too much focus on the farms and little interest in the necessary strategic changes that the company must do in order to survive internationally; (2) too much focus on the food industry and the development of strategies with too much distance between the co-operative firm and the farm. As described by Rabobank, this is a difficult task, since the two mentioned factors pull in opposite directions.

In general terms the first four risks faced by the two studied co-operatives can be considered similar if not identical. The following, related to the capital structure, governance structure, selected FMSM and organisational structure, are different for each co-operative as the structures of the co-operatives differ as well.

In terms of conflicts and risks associated with the capital structure and financing mechanisms, both co-operatives are facing different potential conflicts, mainly related to the fact that Fonterra has an uniform shareholding category (i.e. all suppliers are shareholders uniformly), where in Zespri suppliers do not necessarily have to be shareholders. In the case of Fonterra, the conflicts are associated to the potential discouragement of new entrants and the delivering of distorted production signals to suppliers. In the case of Zespri, the risks and conflicts are associated with the potential conflicts of interests between shareholders and non-shareholders, as well as the financial limitations the current capital structure could represent for international growth plans.

It can be said that the same conflict that Zespri faces in terms of its share dividend versus fruit payout is also faced by Fonterra in terms of wealth creation versus milk payout, and has only one possible solution, that is, joint maximisation of the benefits of both suppliers (growers/farmers) and shareholders: "*Patrons [supplier-shareholders] should be provided with signals in order to evaluate their co-operative on this dual relationship*" (Kyriakopoulos & Van Dijk, 1997, p.4).

Both co-operatives face, although to a different extent, the conflict of the governing versus representing roles of their Directors. Both Fonterra and Zespri need international business skills, which may not necessarily be among its farmer/grower-Directors. In the case of

Fonterra, as the co-operative has a considerable size (about 13,000 suppliers) the nine farmer Directors could struggle to fulfil both roles efficiently. In the case of Zespri, although it has a smaller quantity of supplier-shareholders (2,500), which are mainly concentrated in the Bay of Plenty region, its system of reconfirming appointed Directors might represent a further limiting factor. Both co-operatives run the risks of having experienced politicians rather than business governors in their Boards.

Both companies are entering new FMSMs, strategic alliances in the case of Fonterra and licensing agreements in the case of Zespri. Both companies have to learn quickly the advantages and disadvantages of these collaborative business relationships, but in general terms it can be said that in both cases the potential benefits largely outweigh the risks. In the case of Fonterra's, the DPA alliance will bring together the two companies often seen as the world's leader in highly differentiated dairy products (Nestlé) and the leader in partly differentiated and bulk dairy products (Fonterra) (Dobson, 2001). In the case of Zespri, the licensing of its successful ZESPRIT™ Gold kiwifruit to producers in complementary countries can only be beneficial. The only risk in that respect is the potential damaging of the Zespri brand by marketing product of a different country of origin under the same brand, therefore it is critical that the company ensures that the externally sourced product is up to the required specifications, that is, to Zespri standards.

By internationalising its capabilities and knowledge, both companies are running the risk of a real or perceived disadvantaging of its supplier-shareholders. On the other hand if the companies do not internationalise their capabilities to a full extent, they run a considerable risk of failing offshore. Zespri has decided to internationalise its capabilities to the full extent, although its strategy is proving slow to implement. In the case of Fonterra, the company is already internationalising its off-farm capabilities through its network of subsidiaries. In terms of the internationalisation of its on-farm capabilities (e.g. dairy farming technologies) the company does not have a clear position on this yet.

Finally, due to its unique organisational structure, Zespri can face potential conflicts of being a co-operative/corporate hybrid, but these conflicts are likely to be theoretical rather than real, such as the lack of a feeling of ownership among supplier-shareholders.

6.2 Critical factors in the internationalisation of agricultural co-operatives

6.2.1 Organisational structure

Co-operative organisational structure has been the subject of several studies and although some discrepancies exist, it can be said that in general terms a pre-determined successful structure does not exist: *“Structure is important, but while successful co-operatives have adopted some common structural elements, the appropriate structure does differ from co-operative to co-operative, since the problems and stresses that each co-operative faces are different”* (Fulton & Gibbins, 2000).

Fonterra has a pure co-operative business structure while Zespri can be classified as a co-operative hybrid. Each structure is the result of specific industry conditions.

The generation of potential conflicts in co-operative hybrid companies has been the subject of several case studies like the ones undertaken on the publicly traded co-operative Saskatchewan Wheat Pool in Canada (Ketilson, 1997), the Co-op/PLC Kerry Group in Ireland (Bager, 1997); and the Mondragón Co-operative Corporation in Spain (Huet, 2001), a corporation grouping over 200 co-operatives with total revenues of US\$ 5 billion per year.

In this respect it is interesting to note the comments of Alistair Betts, current Director of Zespri and former senior executive of the NZDB: *“It’s not about structure, it’s about management. You have good co-operatives and bad co-operatives, good companies and bad companies; it’s about management. In my view it doesn’t change a thing, it’s about management, it’s about the Board, the quality of the Board, the quality of the executives and the interaction of the executives with the Board, that’s what it is about”* (Alistair Betts, Director of the Board, Zespri Group, personal interview, August 2002).

Research backs up Mr. Betts's comments, as there is a substantial body of literature that shows that co-operatives are as profitable and efficient as their IOFs counterparts (see for example Gantzoglani, 1997; Ling & Liebrand, 1998). Still, the lack of specific studies comparing the performance of pure co-operatives versus co-operative hybrids has to be noted.

In the specific case of Zespri it can be said that the current supply structure can be identified as a major cause of conflict and distancing rather than the co-operative hybrid structure per se. The solution for Zespri is not easy as the other main actors in the New Zealand kiwifruit industry (i.e. supply entities) have become powerful actors and could eventually aim to become marketers themselves and therefore compete with Zespri in a deregulated environment.

In summary, based on the Fonterra and Zespri case studies and also from overseas case studies, it can be stated that as long as the co-operative remains in control of its supplier-shareholders, the specific structure the co-operative adopts would be irrelevant, although it has to be kept in mind the risks associated if the main operations of the co-operative pass into the hands of outside owners, where the whole purpose of the co-operative would change and emphasis would no longer be on providing benefits for members, but rather on profits to investors. In short, structure is important, management is fundamental.

6.2.2 Company and supplier-shareholders relationship

The deterioration of the relationship between co-operatives and supplier-shareholders has been identified by co-operative researcher as a critical factor in the generations of conflicts, especially in modern co-operatives where differences with IOFs have increasingly disappeared (Cote, 2000).

In Fonterra the Shareholder Services department is the primary interface of the company with its supplier-shareholders. Based in Auckland, Shareholder Services includes the following four divisions: (1) Field teams, made up of the Field Representatives (35 people across the

country), the Milk Quality specialists (six people), and the Environment specialist; (2) The Contact Centre, which has 25 operators, represents the main point for supplier-shareholders for all questions about the company; (3) Financial Services, who are in charge of payments and all financial matters, having also under its structure the internet information provider, Fencepost.com; and (4) Shareholder Relations, which works across the different sections to manage communications with shareholders and other key stakeholders such as the Shareholders' Council.

In Zespri's current supply structure there is a triangle made up of grower-suppliers-Zespri, where the day-to-day operational, logistical and financial interface is between Zespri and suppliers (twelve entities), who in turn are in charge of communicating down to growers. In general terms, although the company moved its headquarters from Auckland to Mount Maunganui, the major growing area, in order to get closer to its grower-shareholders, growers are either two or three stages away from Zespri for both operational as well as financial issues. The structure, although with some efficiency benefits, has been identified as a source of concern, especially for growers who feel disconnected from Zespri. In direct response to these concerns, the company established the position of Grower Liaison Managers (two people), whose function is to work as a two-way communication structure; downwards they present the latest operational information and market summaries and clarify existing doubts to growers; upwards they listen and pass on feedback from growers on topical issues.

The literature identifies that as co-operatives and their membership mature, less emphasis is placed on services and democratic processes and more on price/payout, resulting in a difficulty in differentiating them from IOFs (Fulton & Gibbings, 2000). Therefore, the challenge for Fonterra and Zespri is to differentiate themselves by providing a premium service and develop ownership feeling among their supplier-shareholder base. Besides the provision of services, other differentiating features include the option to members to participate further up in the profits of another segment of the agricultural industry. The US Premium Beef, Naicam Co-operative and Spring Wheat Bakers in North America are some examples of co-operatives that have successfully differentiated themselves from their peers. The differentiation from competitor IOFs by offering a number of highly integrated services in single geographical locations may prove to be a successful strategy as the so called

'superlocals' like the Canadian Naicam Co-operative have found recently. Naicam Co-operative provides agronomy services, crop scouting, fertiliser and chemical sales, equipment rental services, and financial services.

6.2.3 Governance structure

Co-operative governance is an extremely contemporary debate. Davis (2001) undertook a comprehensive review of that debate. According to Davis, co-operatives need governance strong enough to maintain their co-operative identity and flexible enough to adapt and /or resist today's competitive market.

Fonterra has a governance structure made up of three main bodies: (1) Executive management, (2) the Board of Directors (together with management are the governors of the business), and (3) the Shareholders' Council as the representative body. For all very important decisions and for the election of the Directors of the Board, members have a direct vote, for all other matters Directors of the Board decide on representation of farmers. Zespri has a very flat governance structure, consisting of only the Governors of the business, comprising Executive Management and the Board of Directors, and the grower-shareholders. Although there is a representative body, Kiwifruit Growers Incorporated (KGI), this is totally independent from the company and has no legal powers.

Governance constraints, specifically related to the lack of skilled Directors, have been identified by co-operative researchers as key limitations for co-operatives in the process of internationalisation (Cook, 1997). In the case of both studied co-operatives the Boards of Directors are made of farmer/grower-Directors and appointed-Directors, in order to broaden the skill and knowledge base of the Board and to complement elected-Directors knowledge. In Fonterra the mix is made up of nine farmer-Directors and four appointed-Directors, while in Zespri's case there are six grower-Directors and two appointed-Directors, although Zespri has the peculiarity that appointed Directors have to be re-confirmed by shareholders at each AGM.

The Executive Management team, led by the CEO, is responsible for the day-to-day management of Zespri Group. In both cases the Executive Management team is totally external to the co-operative with no supplier-shareholders among them. In Zespri, the only exception to this rule is in the Executive Chairman role, which was temporarily created, but will finish existing in December 2002, with the new Chairman of the Board leaving all executive duties to the incoming CEO. The challenge in this respect for both co-operatives is to attract and retain competitive and motivated management. An appropriate reward system preconditions acquisition of skilful management. In turn, effective performance measuring mechanisms must be in place.

In terms of the interface between Directors and farmer-shareholders in Fonterra, Directors fulfill their representing/communication role in several ways and through different mechanisms, but in general terms two Directors attend to meetings with farmer-shareholders and listen to feedback on topical issues. The Shareholders' Council is a representation of 46 Councillors for 13,000 shareholders, being responsible for the specific group of farmer-shareholders within their ward, fulfilling an upward communication role, by presenting farmer-shareholders' views and concerns to the Board of Directors. For fulfilling their role each one of the Councillors has established 'supplier networks' which operate in different ways, although in general terms this is an area that needs to be improved. In Zespri, Roadshows (four per year), play an important role in terms of integrating grower-shareholders and governors. Other mechanisms such as small group meetings are also important.

In terms of avoiding and/or overcoming the potential conflict between governing and representing roles that co-operative's Directors may face, the solution probably lies in a balance between the two roles. Directors cannot abandon communication with their shareholder base. Although communication is likely to diminish as shareholder numbers increase, the closeness between Directors and farmers/growers is crucial. The task demands a time commitment from directors that could be exhausting, rotation therefore would be key.

6.2.4 Knowledge creation and R&D

Knowledge creation, including research and development, is a key factor for the success of any company in today's global markets. Co-operatives are no exception and Fonterra and Zespri have understood this. Both co-operatives have an R&D budget equivalent to about 0.6-0.7% of total revenues, mainly carried out by their independent R&D business units, the Fonterra Research Centre and Zespri Innovation respectively. In both cases, R&D can be defined as a core capability, and the amount of leading products and processes currently in the global dairy industry in the case of Fonterra and the successful ZESPRI™ Gold kiwifruit in the case of Zespri are proof of that.

Fonterra's global R&D network consists of the FRC, Development Centres, Technical Centre of Excellence and a considerable amount of global R&D partnerships. This represents a competitive advantage difficult to replicate by competitors. Zespri's R&D subsidiary, Zespri Innovation, on the other hand, although considerably smaller, represents a differentiating feature for the fresh fruit industry. In both cases, their R&D efforts are good parameters of their success. Having said this, both co-operatives should increase their R&D expenditure in order not to be left behind by their competitors. In terms of Fonterra's competitors, for example, Nestlé spends 1.4% of total sales in R&D and the Kerry Group between 2-3%.

The other important challenge for these two co-operatives in order to maximise their R&D efforts, is to leverage their capabilities globally. The Saskatchewan Wheat Pool (SWP), one of Canada's biggest co-operatives, for example, created the International Business Division to market the SWP's technology to other countries.

The internationalisation of knowledge created in New Zealand as well as the internalisation of knowledge created in subsidiaries, is a key aspect for the success of co-operatives in today's global markets. The risks of internationalising knowledge and capabilities of New Zealand origin and leveraging its suppliers' capabilities worldwide can be overcome by a continuous creation of knowledge onshore, in other words by continuously creating a time gap, letting

supplier-shareholders be the first ones in getting access to new technologies, before letting offshore suppliers have access to it, although the time gap cannot be too long or the co-operative runs the risk of losing that knowledge.

6.2.5 Capital structure and financing

It is important to analyse both the implications of the capital structure over the plans of internationalisation as well as the implications of an internationalisation strategy over the co-operative's capital structure.

Capital has been traditionally identified as the major limitation for co-operatives to internationalise (Cook 1997; Salaberria, 1997; O'Connor & Thompson, 2001). Buccola et al. (2001) identified co-operative's capital subscription methods as the most important factor influencing co-operatives' overseas involvement. In general terms it can be said that capital acquisition is a problem in co-operatives because members often have too little incentive, little sense of ownership, to supply capital to the co-operative. In order to overcome these limitations co-operatives have been introducing alternative financing mechanisms and innovative capital structures (Kyriakopoulos & Vand Dijk, 1997). The implications of these mechanisms remain unclear in most cases.

Fonterra has a pure co-operative capital structure, where the totality of the company's equity (NZ\$4.5 billion) is the property of its farmer-shareholders. In 2002, further capital strengthening of the company was achieved through a \$200 million issue of capital notes (listed on the New Zealand Stock Exchange) and a \$1.02 billion issue of Eurobonds. Fonterra, and the NZDB previously, were able to raise capital from its members and also from strategic partners, through JVs and alliances, in order to fund offshore investment. In that respect it can be said that Fonterra has not faced the capital limitations that traditional co-operatives face when investing overseas. Still, as further expansion is the goal and as investments become more and more distanced from the 'core business', the question arises again, how will Fonterra finance future offshore investments?

The main component of Fonterra's capital structure is the Fair Value Share (FVS). All supplying shareholders own one share (FVS) for every kilogram of milksolids they produce. The price of the FVS is determined by the company within a range independently set by the company's valuer (currently Standard & Poor's) on a yearly basis and is not changed until the next season. To determine the price of the FVS, all assets of the business (tangibles and intangibles) are added up, all the liabilities are taken off and then divided by total production. Although milk payout still remains as the essential measure of short-term performance of the company for supplier-shareholders, changes in the value of the FVS provide a measure of long-term value creation.

Kyriakopoulos (2000) stated that as member heterogeneity increases, it becomes necessary to introduce equitable member treatment mechanisms, in other words that the cost and benefit allocation of joint marketing activities should recognise the differences of members in cost structures and value-added. He also argues that members should be given market alternatives (e.g. different share types, bonds).

Zespri in turn, has a co-operative hybrid capital structure where only New Zealand kiwifruit grower-suppliers can own shares, but growers do not have to own shares to supply to the company, in other words not all suppliers of fruit are suppliers of capital, or their shareholding in Zespri may not be in proportion to their submitted volumes, which means that within the company there are three categories of growers (grower-shareholders, non-shareholder growers, and low shareholders). Another peculiarity of Zespri's capital and ownership structure is that grower-shareholders can only vote in proportion to their production and although shares are fully tradable between growers and no shareholding limits exist, the share market can be defined as relatively illiquid and in general terms shares are sold together with orchards. The proof of that is currently no shareholder has more than 1% of total shares

Although after a partly subscribed share issue (about 60% of shares were subscribed) Zespri announced in 2001 that it was looking at alternative ways of financing and increasing its capital levels, the fact is that no new mechanisms have been implemented and Zespri, by simply retaining profits has been able to increase its capital base to over \$22 million and even

pay a dividend to its shareholders. It has to be stated that even though Zespri's capital base may soon be sufficient to cover most of its normal commercial risks, it is unlikely to be sufficient for major offshore investment plans. If Zespri decides to undertake a major international project it is likely that it will have to test the boundaries of one of the following innovative financing mechanisms: JVs and strategic alliances, bond issuing, proportional tradeable shares, external participation shares and public quoted shares (Kyriakopoulos & Van Dijk, 1997).

External sources of capital are an option, although as Dobson (2001) stated, not the panacea: *"An important lesson from the Kerry Group's experience is not to attribute too much of the firm's success to Kerry's decision to convert to a co-operative/public limited company. While Kerry used equity capital raised in London and Dublin stock exchanges to make some of its highly successful acquisitions, most of the firm's major acquisitions were made with debt. The success of the acquisitions probably is more a tribute to good management than anything else"* (Dobson, 2001). Again, capital structure is important, management is fundamental.

The challenge for modern co-operatives is to develop individualised capital mechanisms by which farmers/growers would wish to participate in profits from value-added enterprises versus simply receiving a payout for their products. A key feature of New Generation Cooperatives (NGC) is the ability of members to participate directly in the returns generated by a value-added enterprise. This point is of extreme importance for both Fonterra and Zespri (to a lesser extent) as they increasingly get involved in value-added activities far from the core business.

Some European dairy co-operatives have been introducing individualised capital mechanisms into their capital structures over recent years. The Dutch Friesland Coberco represents a good example, having two categories of shares: A shares held by the co-operative collectively; and the tradeable B shares certified to individual current and retired members. In the specific case of Fonterra, the introduction of individualised capital mechanisms would help Fonterra to overcome (to a certain extent) the identified potential conflicts, which are, signal distortion and new entrants discouragement. In the case of Zespri, although the company's shares are

individualised capital mechanisms, the challenges are in attracting suppliers to invest in the company, something that has proved difficult so far.

As Van Bekkum (2001) stated, as co-operatives shift from commodity to value-added strategies (value added processing, vertical integration, brand development), need to move away from collective organisational structures and introduce more individualised member incentives. Van Bekkum recommends an adjustment of internal structures prior to accessing external capital (e.g. stock markets).

In terms of the generation of conflicts of interest between different categories of shareholders within the co-operative, as Fulton & Gibbings (2000) describe in their study of the Kerry Group, this has not been an issue, as the company has over-performed, meaning that enough profit to pay competitive prices to suppliers has been generated. Moreover there is even the possibility that if co-operatives chose to do so, they could cross-subsidise suppliers with profits generated by other added-value parts of the business.

Maximisation of the supplier-shareholder's welfare is the optimal solution. In other words, joint maximisation of the benefits of members both as investors and as suppliers (Sexton & Iskow, 1988 cited in Kyriakopoulos & Van Bekkum, 1988). Kyriakopoulos & Van Bekkum (1988) recommend a clear differentiation of the investor (dividend) and transaction (payout) profits through differentiated shares that would send appropriate signals to both. Zespri has adopted such mechanisms, but at this stage the dividend is considerably smaller than the payout, which makes supplier-shareholders to concentrate their attention on the second signal.

6.2.6 Communication

Co-operatives in the process of internationalisation need to be constantly communicating with their supplier-shareholders, informing them (within commercially-sensitive boundaries) about what the company is doing both onshore and offshore. Both studied co-operatives use a mix of face-to-face, printed, and electronic/internet communication mechanisms.

In terms of the printed communication mechanisms, besides Annual Reports and letters, both companies use monthly magazines/letters to keep shareholders informed: 'Farmlink' in the case of Fonterra and the 'Kiwiflier' in Zespri. Zespri also utilises a bi-monthly magazine, the Kiwifruit Journal, to access a broader audience. Fonterra's Council Report represents a unique mechanism, which consists of a totally independent document sent strictly to all farmer-shareholders in which the Council gives detailed information about the Council activities over the last year and more importantly, a detailed analysis of the Co-operative's operational and financial performance, fulfilling in that way its performance monitoring role.

Although electronic channels have the biggest potential of the three mentioned channels, both co-operatives have experienced problems in trying to implement them due to structural (rural access) and cultural reasons, although Fonterra's Fencepost.com is a far more advanced system and Zespri's grower website is at this stage mainly an electronic version of the company's communications channels.

Fonterra's Shareholder Council fulfils an important role in terms of upward communication with downwards communication being the responsibility of Directors. Zespri's Grower Liaison Managers, fulfil a two-way communication role, although they can be considered limited for overseeing 2,500 growers. Also, as one of the biggest concerns of grower-shareholders is related to lack of communication related to payments and financial information, their existence does not address that problem. Fonterra Directors' meetings and Zespri's Roadshows are the mechanisms used to integrate farmers/growers with governors, by that way avoiding/minimising the aforementioned risk of shareholders' distancing from governors. Through these mechanisms the co-operatives communicate to supplier-shareholders the evolution of the co-operative's strategy and discuss topical issues with the shareholder base.

Interesting to highlight in this respect is the case of Agropur, a Canadian dairy co-operative with about 5,000 members. Agropur has a network of 700 facilitators (one for every seven members) whose role is to inform members about the co-operative and to forward questions and concerns upwards. A 'solidarity committee' is in charge of supervising the activities of

the facilitators by establishing meeting schedules, program contents, and topics for consideration that are suggested to the facilitators.

It has to be stated that although both co-operatives, Fonterra and Zespri, have faced communication problems with their supplier-shareholders over recent times, their set of communication structures and mechanisms can be considered comprehensive if compared with other co-operatives worldwide. Therefore, the challenge for these co-operatives lies in the continuous evaluation of the mechanisms currently in place, rather than in the implementation of new ones.

6.2.7 Education

Education of members was among the twelve original co-operative principles of the Rochdale society back in 1844. Education was somehow systematically discarded with contemporary co-operative principles being just three: the user-owner, the user-control and the user-benefit principles (Barton, 1989; see Table 3, chapter 2.1.1). Although this does not mean that co-operatives abandoned totally their educating role, it gives an idea of the importance it has in modern co-operatives. It is likely that education will eventually become a key factor in modern co-operatives as co-operative business become increasingly complicated. Shareholder's education has to be a continuous process, that helps members see the connection between their self-interests and the interests of the co-operative, encourages innovation, adaptation and efficiency. Also, education is an important way of creating a sense of ownership and control in the co-operative (Fulton & Gibbings, 2000).

Both, Fonterra and Zespri have traditionally been very active in the technical up-skilling on their farmers/growers and as a result New Zealand dairy farmers and kiwifruit growers are world leaders in terms of production and efficiency levels, representing in fact core capabilities of both companies. Both companies have structures in place for that purpose, Fonterra through its Field Reps, Milk Quality Specialists, and Field days; and Zespri through its Tech Transfer department, Field days and Innovation Seminars. While the aforementioned technical up-skilling is an area that must not be abandoned, especially if the companies decide

to internationalise that knowledge and leverage it through its subsidiaries, this project is more concerned with the education of supplier-shareholders in terms of the understanding of their co-operatives' functioning as well as the industry they operate in.

The education and up-skilling of supplier-shareholders must cover the whole shareholder base including current Directors, representatives (Councillors in the case of Fonterra) and supplier-shareholders without any representative or governing position. Directors at both companies receive further training once they become elected. This is an area that should be emphasised, as Directors, being key players of co-operatives, need to be constantly up-skilling, to meet the business requirements.

By educating supplier-shareholders about the co-operative: first, the level of understanding of the co-operative's shareholder base is elevated, which puts the company in a better position for undertaking strategic changes with the support of its shareholders. Second, the level of knowledge of shareholders is raised, who in turn become able to question Directors on strategic and background issues rather than superficial ones, elevating the discussion level of the co-operative as a whole, eventually leading to an improvement in the efficiency of the company. Third, a pool of highly skilled people to eventually become leaders is created, which again, is in the best interest of the company and its performance in a global context.

Co-operatives need to maintain and build their support of member, representatives and Directors education. This education is key to addressing the member ownership and control problems that co-operatives face.

The education and up-skilling of supplier-shareholders in the studied co-operatives occurs through several avenues, including most of the communication mechanisms previously mentioned which also work as education mechanisms.

In the specific case of Fonterra, the company has demonstrated a major commitment towards the education of shareholders through the implementation of its Industry Training and Development Programme. The programme has three stages: introductory programme, intermediate programme, and advanced individualised programme. In terms of Zespri,

although the company sponsor selected growers for a leadership course at Lincoln University, there are two integrative mechanisms used by Zespri that are worthy of highlighting as educating mechanisms. The first one is the Industry Workbook, an extensive document sent to all growers in September 2001. The second one is Zespri's Offshore Study Tours.

Co-operative education is increasingly becoming important again and this can be seen in several co-operatives worldwide. The Canadian co-operative Agropur, for example, annually organises more than 6,000 associative days for its members, which last from two to four days. Topics include the co-operative distinctive nature, its democratic framework, its history, the role of each member and their strategic activities. Training sessions for facilitators are focused on their role, acquiring knowledge about the sector, skills development, etc.

Education is a key factor in the integration of supplier-shareholders and co-operatives. If considered a unique service provided by the co-operative, education has the potential of creating a strong sense of belonging and motivation among supplier-shareholders, again, differentiating them from IOFs. In the absence of education, the complexity of the issues that co-operatives are currently facing could easily lead to the abandonment of participation by the shareholders, which is by all means a risky situation.

One key aspect that affects both studied co-operatives is the lack of co-operative education existent in New Zealand. The absence of co-operative education which exists in New Zealand⁶² contrasts with the amount of co-operative's specialised centres existent in other developed countries around the world. Examples include the University of Wisconsin Co-operative Centre (UWCC) in the United States, the Centre for the Study of Co-operatives at the University of Saskatchewan in Canada and the Netherlands Institute for Cooperative Entrepreneurship (NICE) at the Nyenrode University among many others (Appendix VI).

If New Zealand co-operatives aim to maintain and improve their competitiveness in world markets, they will have, together with New Zealand Universities, push for the development of co-operative courses to be included in the curricular of agricultural and horticultural students

⁶² Probably the only co-operative course currently existent in New Zealand Universities is a Canterbury University paper dictated by Allan Rob.

as well as the establishment of Centres of Excellence dedicated to the study of co-operatives and eventually follow the example of co-operatives offshore like the Saskatchewan Wheat Pool in Canada, which provides financial contributions to the Centre for the study of Co-operatives at the University of Saskatchewan, dedicated to research and teaching about co-operatives.

CHAPTER SEVEN: CONCLUSIONS AND RECOMMENDATIONS

7.1 Conclusions

Internationalisation of agricultural co-operatives is a worldwide trend and has been identified by several studies as one of the key challenges co-operatives are currently facing.

Based in a conceptual model developed in this study, internationalisation was defined as the process by which agricultural co-operatives are involved in one or more of the following Foreign Market Service Modes (FMSM): exporting, Foreign Direct Investment (FDI), external sourcing, knowledge agreements, international alliances and transnational co-operatives.

The main purpose of this study was to answer the research question of:

How can agricultural co-operatives internationalise without generating conflicts with or distancing themselves from their members?

This main question was in turn subdivided into the following two questions:

- 1) What are the available strategic alternatives to agricultural co-operatives to internationalise? What are the implications of these alternatives for the co-operative and its members?
- 2) What are the potential conflicts that may arise because of the internationalisation of agricultural co-operatives? How can these be best overcome and/or avoided?

In order to try to answer these questions, two case studies were analysed, Fonterra Co-operative Group and Zespri Group Limited. Even though both companies are New Zealand agricultural co-operatives, they have significant differences. While Fonterra is a dairy pure

co-operative owned by over 13,000 farmer-shareholders, with annual revenues of NZ\$13.9 billion and a staff of about 20,000 distributed over 90 subsidiaries; Zespri on the other hand, is a kiwifruit hybrid co-operative owned by about 2,500 grower-shareholders, with annual revenues of about NZ\$800 million and a total staff of just over 180.

In terms of their internationalisation process, Fonterra is involved in five out of the six FMSMs of internationalisation, from simple exporting to the formation of international alliances, doing business in over 120 countries. Zespri on the other hand, is involved in four out of the six FMSM: export, FDI, external sourcing and knowledge agreements, with the first two being the ones traditionally used by Zespri (and previously by the NZKMB) and only in recent years has Zespri slowly started to source kiwifruit from northern hemisphere countries and to license its ZESPRI™ Gold kiwifruit variety. In general terms, it can be said that Fonterra is far more advanced in its internationalisation process than Zespri.

In terms of the sixth stage of internationalisation, so far none of these two co-operatives, Fonterra and Zespri, have manifested intentions of becoming transnational co-operatives by accepting offshore suppliers as shareholders. At present, both companies are involved in business relationships with co-operatives offshore. The importance of this is that collaborative business relationship (JVs and alliances) with foreign co-operatives can be the first step of a process that could end up with the formation of a transnational co-operative, as it has happened with other co-operatives overseas.

The key contributions of this study are:

- A comprehensive literature review in the topic of internationalisation of agricultural co-operatives, a topic that although has been marginally discussed by several researchers, had not been developed in depth so far.
- The development of a model of internationalisation of agricultural co-operatives. The new model, which expands existing ones, proved useful for organising the vast array of Foreign Markets Service Modes (FMSM) used by the two studied co-operatives and of others found in the literature. The model identifies six main FMSM: exports, FDI,

external sourcing, knowledge agreements, strategic alliances and formation of transnational co-operatives.

- The identification of key risks and conflicts faced by the studied co-operatives in their internationalisation process.
- The identification of critical factors (structures and mechanisms) in the internationalisation of agricultural co-operatives, considering the dual relationship between the co-operative's performance in the international markets and the integration with supplier-shareholders in the local side

7.1.1 Risks and potential conflicts

Based in the information gathered in the case studies, the following risks and potential conflicts faced by these two co-operatives in their internationalisation process were identified:

- **General risks**

- **Failure of overseas ventures:** the first and most obvious risk co-operatives face when developing businesses in foreign markets is the possibility of failure. As co-operatives' foreign business portfolios get bigger and more complex, tighter control mechanisms must be in place.
 - **Real or perceived competition between externally sourced production and supplier-shareholders' production:** as co-operatives start to source non-members' product, the real and perceived competition with supplier-shareholders' production has to be taken into account and managed carefully.
 - **Real or perceived deficient service to supplier-shareholders:** as co-operatives grow on the international side, they cannot (regardless of its veracity) be perceived as giving more attention and resources to offshore operations than to their supplier-shareholders on the local side.
- **Distancing of supplier-shareholders (disenfranchising).** Probably the most important risk co-operatives face when internationalising is the distancing of themselves from

their supplier-shareholders. The causes behind this include the inability of the co-operative to differentiate itself from IOFs, increased co-operative size, lack of members' understanding due to business complexity, lack of members' participation, and others. Whatever the reasons or the combinations of them, the mentioned distancing can have fatal consequences both on the local side and the international side.

- **Risks associated with the selected FMSM.** Depending on where they are situated on their internationalisation stage, co-operatives face different risks, especially when entering new FMSMs the co-operative is not familiarised with. In the case of Zespri, as it is entering into licensing agreements and external sourcing of product under a single brand, the biggest risk is brand damaging. In terms of Fonterra, as the company has entered into a strategic alliance with Nestlé in the Americas, the biggest risks are related with 'asymmetrical benefiting' among partners and unfair competition outside the venture's geographic area.
- **Governance related conflicts.** Directors of co-operatives in the process of internationalisation are likely to face a conflict between their governing and representing roles. If Directors concentrate too much on their governing role, they can get distanced from supplier-shareholders, on the other hand if they concentrate too much on the representing role, co-operatives run the risk of being poorly governed/managed. As a consequence of this and of the nature of democratic voting structures, co-operatives run the risk of having experienced politicians rather than skilled businessmen in their Boards. As co-operatives grow, representing bodies (e.g. Fonterra's Shareholder Council) play a key role in terms of integrating shareholders and governors.
- **Capital structure and financing related conflicts.** Because co-operatives' capital structures are different, the potential conflicts they face also differ. In the case of Fonterra, the identified conflicts are associated with the potential des-encouragement of new entrants and the delivering of distorted production signals to suppliers. When JVs are utilised as FMSM, the risk of control dilution has to be acknowledged,

although this is likely to be minimal if partners' strategic objectives are aligned. In the case of Zespri, the risks and conflicts are associated with the potential conflicts of interests between shareholders and non-shareholders, as well as the financial limitations the current capital structure could represent for international growth plans.

- **Co-operative/corporate conflicts.** The generation of potential conflicts when co-operatives hybridise their structures has been studied by several researchers. Due to its co-operative hybrid structure Zespri can face potential conflicts between shareholders and suppliers, which in the case of Zespri are not necessarily the same, as the company grows internationally. Also, the lack of differentiation from IOFs can lead to the mentioned distancing of supplier-shareholders. Having said this, in the specific case of Zespri, the supply structure is likely to have a bigger influence in this respect than the organisational structure.
- **Conflicts and risks associated with the internationalisation of knowledge and capabilities:** By internationalising its capabilities and knowledge, co-operatives run the risk of a real or perceived disadvantaging of its supplier-shareholders. On the other hand if they do not internationalise its capabilities to a full extent, from on-field production to marketing of final products, the risk of failing offshore increases considerably.

7.1.2 Critical factors

The following factors (structures and processes) were identified as being key for agricultural co-operatives in their process of internationalisation:

- **Organisational structure:** The experience of the studied co-operatives confirm existing studies that deny the existence of pre-determined successful co-operative structures. Although some common structural elements exist, appropriate structures differ from co-operative to co-operative, according to the specific problems and

stresses that each co-operative face. Structure is recognised as an important factor, but management as fundamental.

- **Governance structure:** In order to broaden the skill and knowledge base of farmer/grower-Directors, co-operatives must appoint external Directors. As co-operatives grow and international businesses become more complex, co-operative should introduce representing bodies that act as a linkage between Directors and supplier-shareholders. Still, Directors should balance their governing and representing roles, although focusing on the first one.
- **Capital structure and financing:** From the supplier's point of view, and as specialised literature recommends, co-operatives should introduce equitable member treatment mechanisms that reflect differences of members in costs structures. From the investor's point of view, co-operatives should also introduce individualised capital mechanisms by which farmers/growers participate in profits from value-added enterprises, according to their preferences. Finally, a clear differentiation of the investor (dividend) and the supplier (payout) profits through differentiated signals (e.g. shares) is critical.
- **Company and supplier-shareholders relationship:** Besides maximising returns for its supplier-shareholders, the challenge for co-operatives is to differentiate themselves from competitors and IOFs by providing a premium service and developing a feeling of ownership among their supplier-shareholder base.
- **Knowledge creation and Research and Development:** A commitment to the continuous creation of knowledge, including research and development (R&D), is a key factor for the success of co-operatives as they internationalise. Internal R&D business units that co-ordinate and/or undertake such knowledge creation appear logical. The internationalisation of knowledge created onshore as well as the internalisation of knowledge created or captured through subsidiaries is a key aspect for the success of co-operatives in today's global markets.

- **Communication:** Co-operatives in the process of internationalisation need to be constantly communicating with their supplier-shareholders, informing them of the company's activities both onshore and offshore. A combination of face-to-face, printed and electronic/internet communication mechanisms is recommendable. Especially important is the maintenance of effective communication channels between shareholders and Directors, either directly or through representatives.
- **Education:** Co-operatives must educate supplier-shareholders in order to (1) elevate the level of understanding of co-operative's shareholder base, putting the company in a better position for undertaking strategic changes; (2) elevate the discussion level of the co-operative as a whole; (3) create a pool of highly skilled people to eventually become leaders. Finally, as co-operatives educate their shareholders base, they will be differentiating themselves from IOFs, generating a feeling of ownership and integrating co-operative and supplier-shareholders.

7.2 Recommendations

Recommendations for the studied co-operatives:

- Evaluation of existing communication mechanisms rather than the adoption of new ones, as both co-operatives' communication process were considered comprehensive when compared against other co-operatives.
- Further development as well as enhancement of benefits among shareholders of internet-based communication channels.
- In the specific case of Zespri, the restructuring of the supply structure (currently under review) must be set as a priority, as this was identified to be a major cause for the distancing of grower-shareholders.

- Adjustment of the governing and representing roles of Directors. In the specific case of Fonterra, Directors should drop some of the communication responsibility, which should be taken by the Shareholders' Council.
- Incorporation of personalised capital mechanisms, by which supplier-shareholders can participate in profits from a value-added enterprises, according to their preferences.
- Full internationalisation of the co-operatives' knowledge and capabilities. In order to avoid disadvantaging supplier-shareholders, co-operatives should create a short time gap when technologies are rolled out within the shareholder base and offshore.
- Evaluation of further internationalisation steps, specifically in terms of becoming transnational co-operatives, as the advantages co-operatives can find in this FMSM widely outweigh the risks.
- Increase of education among the shareholder base. Consider the sponsorship of co-operative research at the University level

Recommendations for further research:

- As this study was mainly descriptive, in terms of the description of the integrative structures and mechanisms being adopted by the studied co-operatives in order to overcome and avoid the identified conflicts and risks, further research should be undertaken for evaluating the effectiveness of the mentioned structures and mechanisms, in other words how well these fulfil their function. A study that includes surveys among the shareholder base would be recommendable for this purpose.
- Also, further research should be undertaken in the whole co-operative area in New Zealand, which at this stage is very limited, something that contrasts with the reality in paddocks and orchards where agricultural co-operatives are very alive.
- Co-operative education at New Zealand Universities should be improved, starting with the incorporation of co-operative courses in the curricular of agricultural and horticultural students and ending with postgraduate courses for co-operative governance. The establishment of co-operative research centres should be evaluated.

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Appendix 1: Information sheet

The challenge of agricultural co-operatives internationalisation

INFORMATION SHEET

Dear Sir:

My name is Ignacio Donoso and I am currently studying for my masters at Massey University. As part of my research I am investigating the phenomenon of internationalisation of agricultural co-operatives.

Serving and representing its members is the main objective of a co-operative, and it is on behalf of that goal, and as a response to external pressures that co-operatives have internationalised in order to successfully compete with their investor-owned counterparts. But this internationalisation and growth process can in turn detonate some internal conflicts, being perhaps the most important the loss of proximity, both physical and psychological, to its members.

The research question that the project tries to answer is:

How can an agricultural co-operative manage the process of growing internationally without generating conflict with or distancing from its members?

This semi-structured interview is aimed at trying to answer that question, and is intended to last approximately 45 minutes. The main areas to be covered include the co-operative internationalisation strategy; structures, mechanisms, and activities to integrate members and co-operative; and the identification of potential conflicts.

The interview will be tape recorded with your approval. Your responses will be held at Massey University in the strictness of confidence at all times. Any output from this research will be in a summarized form only and individual responses will be unidentifiable.

As a voluntary participant you have the rights to decline to participate in the interview, to refuse answer any particular question and to withdraw from the interview at any time, to ask any questions about the study at any time during participation, to provide information on the understanding that

your name will not be used unless you give permission to the researcher, and to be given access to a summary of the findings of the study when it is concluded.

If you have any further queries I would be happy to answer them, so please don't hesitate in contacting me at Massey University, 06 3569099, extension 2453, or at home, 06 3573192, or alternatively my supervisors Nicola Shadbolt at Massey University, 06 3504166, or Bill Bailey at 06 3504166.

Yours faithfully,

Ignacio Donoso,
Agribusiness Masterate student

Appendix 2: Consent form

The challenge of agricultural co-operatives internationalisation

CONSENT FORM

I have read the Information Sheet and have had the details of the study explained to me. My questions have been answered to my satisfaction, and I understand that I may ask further questions at any time.

I agree to participate and I understand I have the right to withdraw from the study at any time and to decline to answer any particular questions.

I agree to provide information to the researchers on the understanding that my name will not be used without my permission. (The information will be used only for this research and publications arising from this research project).

I agree/do not a

gree to the interview being audio taped (please circle one).

I also understand that I have the right to ask for the audio/video tape to be turned off at any time during the interview.

I agree to participate in this study under the conditions set out in the Information Sheet.

Signed:

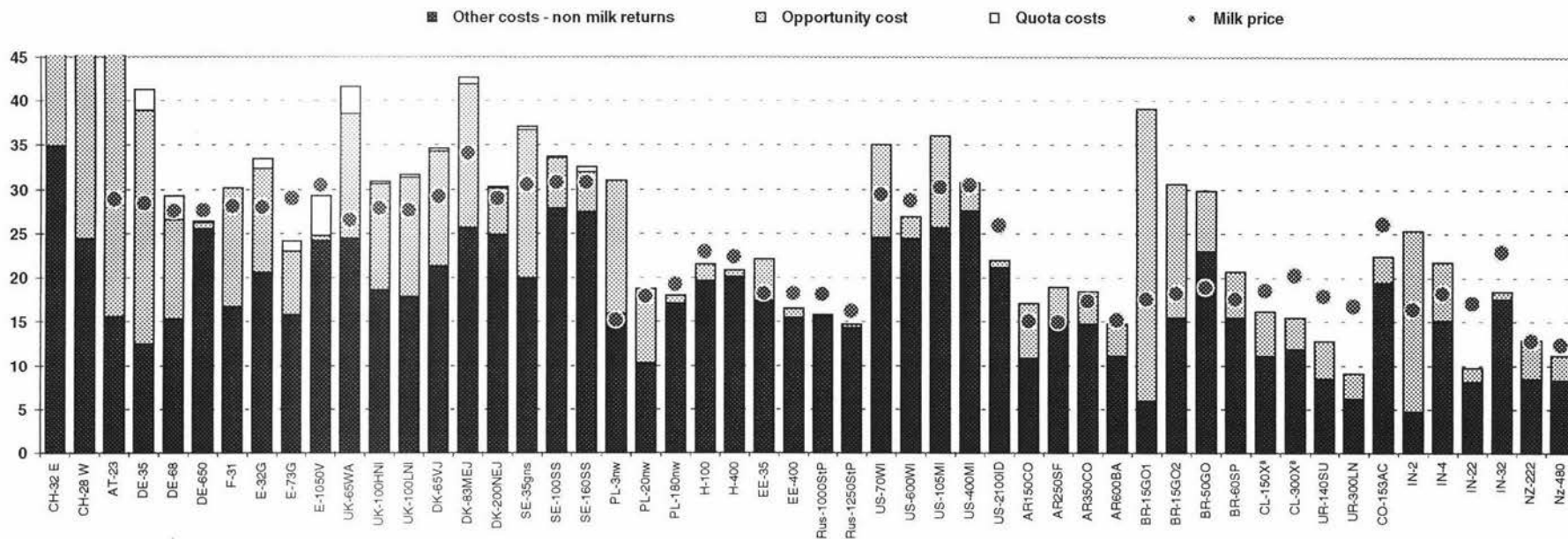
Name:

Date:

Appendix 3: Costs of Milk Production for IFCN member country typical farms



The country names are abbreviated as follows: CH Switzerland AT Austria DE Germany FR France ES Spain UK DK Denmark SE Sweden PL Poland HU Hungary EE Estonia RU Russia US AR Argentina BR Brazil CL Chile UR Uruguay CO Colombia IN India NZ



Source: IFCN (2002) cited by Shadbolt (2002).