Fonterra's Fair Value Shares

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In last week's newsletter I discussed the large New Zealand Dairy Cooperative, Fonterra and their two-tiered governance system with both a Board of Directors and a Shareholders Council. Another unique structure implemented by Fonterra was their system of Fair Value Shares. Fonterra was created in 2001 as the result of a merger between the New Zealand Dairy Board and two of the country's largest dairy cooperatives. The structure included an equity valuation structure called the Fair Value Share which was eventually replaced by true market place valuation systems by changes in 2009 and 2012.

Fonterra is a closed cooperative operating under a delivery rights system. A member must have a share of stock for every unit of milk they deliver. The delivery right ensures that the members who are using the cooperative have contributed the appropriate amount of equity to finance the firm. The Fair Value Share created the potential for appreciation of the value of the delivery rights. The basic idea was that at the end of each year an outside valuator determined the value of the firm based on its earnings and projected future earnings. When Fonterra invested in valued-added activities and built export markets for its products the Fair Value Share could increase in value. That provided members with the incentive to encourage the cooperative to retain funds and build the value of its brands. When a member decided to leave dairy farming and have their equity redeemed they would receive the Fair Value Share and a new farmer purchasing the delivery rights would pay the current Fair Value Share price.

The Fair Value Share was an interesting concept. In my recent research involving cooperative valuation I applied the same concept to grain and farm supply cooperatives. We used accepted accounting principles to project the value of a cooperative based on its projected future earnings and patronage. If that value was communicated to members and they grew to understand it they might be more comfortable with the cooperative making investments that would enhance its future profitability. Of course, in an open membership cooperative the equity does not appreciate in value (as in the Fair Value Share system) so members benefit from investment in infrastructure only through future use and patronage. That creates our classic horizon problems where members with different time horizons have different attitudes toward the cooperative retaining funds for reinvestment versus distributing funds in cash patronage and equity retirement. While it is unlikely that a grain and farm supply cooperative could implement a usage rights system it is interesting to consider how it could address some of our basic challenges.

If you be interested in a future income based value projection of your cooperative, let me know.

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