Case Study Report: Critical Analysis of the Financial Decision Making of a New Zealand Organization

Executive Summary

Fonterra is a New Zealand based dairy co-operative which is present across the globe. The company is the largest firm in New Zealand and is one of the world's most well-known dairy brands. The company is owned by about 10,000 farmers and their families. Data has been gathered from the 2018 Annual Report and then evaluated. For instance, as of the financial year 2018, the company recorded free cash flow worth $600 million and a normalised EBIT of $902 million which was down 22% compared to the previous year. The company has managed to record sustainable growth through prudent decision making, although it had a tough financial year and recorded a net loss for the first time in its history. Various financial analysis tools and techniques, such as common size analysis, ratio analysis, and capital budgeting techniques have been used to evaluate the financial decisions made by Fonterra critically.

Introduction

Financial decision making is made in every organisation, and it is one of the key components of any company's operations. Analysing the financial statements of an organisation allows analysts to identify the key strengths and weaknesses of the company. In addition to this, by conducting a detailed analysis of the firm's financial statements, it becomes easier for an individual to assess whether the company has been prudent in its decision making. Also, the financial statements of a firm can reveal how the company has been managing its operations and investments. These statements can also be used to forecast the future financial performance of the firm (Penman, 2007). Based on the past and current financial statements of the company, this report will analyse the financial decision making of Fonterra and make recommendations accordingly. In addition to this, the report will enlist the key conclusion from the financial statement analysis.

Fonterra is a leading dairy co-operative based in New Zealand. It is one of the prominent companies to come out of the nation. The company is a well-known brand around the world and has over 3300 employees. The company has been recording consistent revenues and has been expanding its operations. Fonterra recorded revenues in excess of $20.4 billion in the year 2018. In addition to this, the company recorded a normalised EBIT of $902 million. However, the financial year 2018 was the first year in Fonterra's history where it recorded a net loss (Fonterra, 2018a; Trechter et al., 2003).

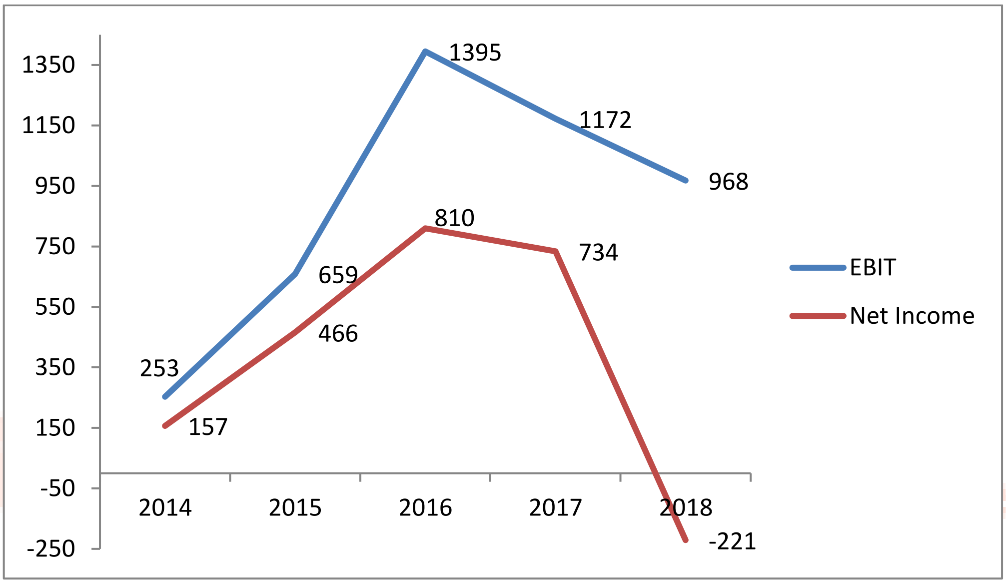
Critical Analysis

In this portion of the report, the past 5 years of financial statements will be analysed. The period covered will be from 2014 to 2018. The major analyses that will be carried out include the basic financial statement analysis, ratio analysis, working capital assessment and analysing whether the capital budgeting decisions were efficient. In addition to this, the general operating environment of the company will be analysed along with its value. Finally, the overall financial health of the company will be assessed and summarised in this portion.

1. Financial Statement Analysis

In this case study, the company's financial statements will be analysed to assess the state of affairs in terms of financial health. In addition to this, the company's financial decision making will be critically analysed. Fonterra has announced its 2018 results for the financial year ended in July 2018. Firstly, the company's net revenues declined slightly during the year, due to the lower demand from the New Zealand market. In addition to this, the normalised EBIT also fell by around 22% compared to the previous year. This is indicative of the fact that the company's current sales strategy is not efficient enough. Further, since the margins are also declining, the company has not focused on higher margin products sufficiently. In addition to this, Fonterra has not managed to control its operating expenses. During the financial year 2018, the company's normalised operating expenses rose by around 7%. This means that the company is spending more on its operations but has not managed to recoup the same in terms of revenues. This is one of the primary reasons why the company's operating profit margin has declined. Given below is a chart showing the company's five year financials:

Chart 1: Fonterra 5 year EBIT and Net Income ($ million)



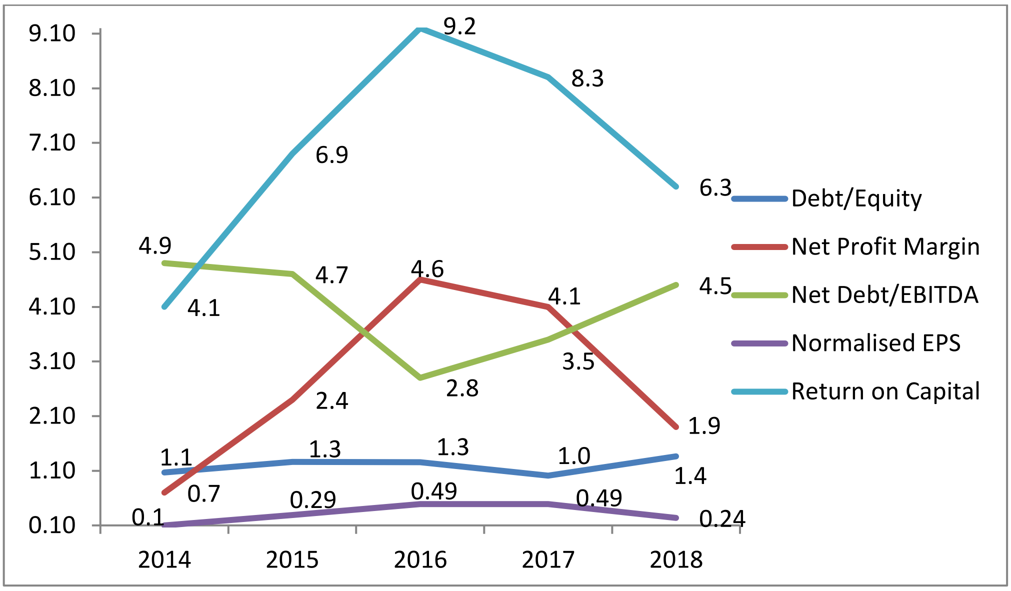
Source: Wall Street Journal (2018)

As the chart above indicates, the company's EBIT and Net Income peaked in the year 2016. Since then the company has consistently witnessed a decline in its bottom line numbers. This gives a clear indication that the company's earnings are heading in the wrong direction and there is an urgent need to reconsider financial decision making as well as the corporate strategy.

2. Ratio Analysis

In this portion, the five primary financial ratios for Fonterra will be analysed. These include the Debt/Equity ratio, the Profit Margin, the Net Debt/EBITDA ratio, the Return on Capital and the EPS ratio. These ratios will provide an indication as to how the company has been performing on various financial metrics such as gearing, profitability, returns as well as margins. Chart 2 below indicates the company's key ratios:

Chart 2: Fonterra 5 year ratios



Source: Fonterra (2018a); Fonterra (2018b)

Debt/Equity Ratio

As seen in the chart above, the company's Debt/Equity ratio increased from 1.1 in 2014 to 1.4 in 2018. This has been driven by the increasing amount of leverage that the company has incurred in order to fund its expansion. An increasing debt/equity ratio is not a good sign for the company because of the perceived risks associated with the increasing debt. Therefore, the company needs to work towards keeping this ratio under control.

Normalised Net Profit Margin

In terms of the Normalised Net Profit Margin, Fonterra improved its margins between 2014 and 2016 from 0.7% to 4.6%. This was indicative of the fact that the company managed to improve sales as well as operating margins during that period. However, since 2016, the company's net profit margin has continued to decline, resulting in lower profits for the firm. As of 2018, the net profit margin has come down to just 1.9%.

Net Debt/EBITDA

The company's Net Debt/EBITDA ratio declined from 4.9 to 2.8 between 2014 and 2016. This was a clear indicator that the company managed to improve its operating performance during the period and also reduced its net debt. However, since the turn of 2016, the ratio has again climbed to 4.5. This shows that the company still has a lot of work to do in terms of improving its operating performance.

Normalised Earnings Per Share (EPS)

The company managed to improve its earnings per share during the period 2014 to 2017. This was indicative of the fact that it managed to grow its revenues consistently and managed to sustain its margins at a stable level. However, in the last year, the company recorded a sharp drop in its normalised EPS. The figure has dropped by more than 50% in the last financial year, indicating that the company's profitability has been reducing in a significant manner. This is a worrying sign for Fonterra.

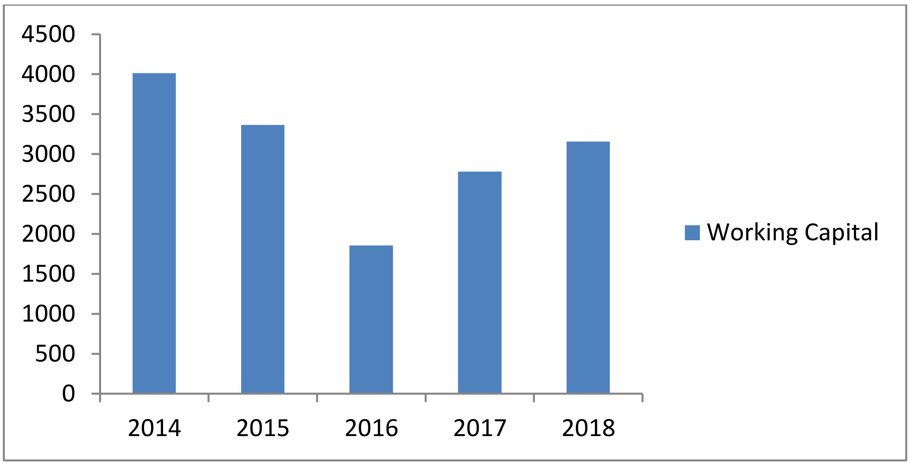
Return on Capital

In terms of the return on capital ratio (including intangibles and Equity accounted investments), the company has been relatively unstable over the past five years. It has recorded inconsistent returns on capital which shows that the shareholders have not always been getting their desired returns. The ratio stood at 4.1% during the year 2014, and now it has improved to reach 6.3% by 2018. However, this is not as high as the 9.2% returns achieved during 2016. Although its overall financial health is still questionable, Fonterra has been providing financial returns to its shareholders.

3. Working Capital Analysis

In terms of the working capital, the company has improved over the past two years. This is despite the fact that Fonterra has faced operating challenges. Chart 3 below indicates the company's net working capital over the period of 2014 to 2018:

Chart 3: Fonterra 5 year Net Working Capital ($ million)



Source: Fonterra (2018a)

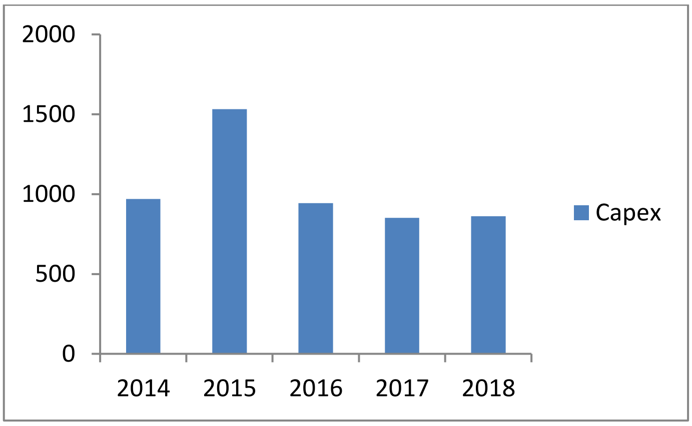
As indicated in the chart above, the company recorded a decline in its working capital between 2014 and 2016. This was driven by the carrying values of inventory and receivables during the years. However, since the year 2016, Fonterra has recorded a consistent increase in its net working capital.

This is indicative of the fact that the company has enough current assets to meet its short-term financial needs. The company has improved on this account in the past two years, but it is still not in as good a working capital position as it was in 2014 (Fonterra, 2018a). Nevertheless, Fonterra has made progress in terms of its net working capital, and this indicates that the company's receivables cycle is also improving in recent years. Fonterra is operating in a high liquidity industry since dairy products tend to have shorter turnaround times. This is beneficial to the company in terms of quickly turning over its inventory compared to other industries such as automotive. Nevertheless, the company has been doing well in terms of its short-term cash generation ability and it needs to continue on this path in the coming years. Higher working capital will allow the company to service its short term obligations in a much better manner. This is always helpful since paying back its creditors in the short term. Also, the company's inventory cycle will continue to flow in an efficient manner, which will be beneficial for its operations.

4. Capital Budgeting Analysis

During the year 2018, the company's capital expenditure grew by just 1%. This increase is not sufficient in order to drive revenue growth. The key expenditures during the year included a number of key projects. These include the construction of a third mozzarella plant at Fonterra's Clandeboye site and a cream cheese plant at its Darfield site. In addition to this, the company also undertook the expansion of its Stanhope plant. This expansion increased the plant's cheese production capacity by around 35,000 metric tonnes. However, as the revenue figures indicate, the company has not spent sufficiently on capital expenditures. Another key aspect is the funding of its capital expenditures. The company has raised external funds in the form of debt (Fonterra, 2018a). This is not a good indicator as the company is becoming more and more leveraged. The company should instead look to budget its capital spending in a better way by utilising equity as well as debt. The chart below shows the company's capital expenditure over the past 5 years:

Chart 4: Fonterra 5 year Capex ($ million)



Source: Fonterra (2018a)

The chart above clearly shows that the company's capex has peaked in the year 2016 and then declined after that. This is a key reason why the company's revenue growth has also stagnated to such an extent. Fonterra needs to improve its capital expenditure in order to plan for future growth. This capital expenditure should be funded by using equity sources along with the already bulging company debt. This will ensure that the cost of capital is kept low and the company manages to maintain its margins. According to the current state of affairs, the company will continue to record losses. Therefore, it needs to rethink its capital budgeting decision making process in the future.

5. Organization Operating Environment and Value Analysis

Fonterra has historically been a well-established company with strong financials. It is one of the better known companies originating from New Zealand (Stringer et al., 2008). However, the company faced a tough operating environment in the financial year 2018. The overall demand for dairy products slowed down in New Zealand, hampering Fonterra's sales numbers. In addition to this, the company also realised lower milk prices. According to its 2018 annual report, the company's realised milk prices were 20% lower compared to 2014. This is a massive decline which indicates a worrying trend for the company. Also, the company has failed to increase its dividend numbers over the past 5 years. This is indicative of the fact that the company is not earning enough to pay out to its shareholders. Another key point worth noting is that Fonterra's share price has fallen 6.7% between 2014 and 2018. On the other hand, its major competitors' share prices have surged significantly over the same period. Companies such as Synlait and a2 Milk have managed to perform very well in the share market, leaving behind Fonterra by a long way over the same period (Coop News, 2018; NZ Herald, 2018).

Another point worth noting is that the company is a global player and wants to expand outside New Zealand, but it does not have sufficient funds to execute its growth plans. In addition to this, since 2014, the company's expansion plans have been driven by debt (Fonterra, 2018d). This is not a good sign for the company as it is highly leveraged now. Almost all of its expenses over the past few years have been funded using external borrowings and very less of it has actually been funded by the farmer owners. This has meant that the company's interest payments have also been on the rise, thereby impacting its ability to maintain its margins. Finally, it is worth noting that the company's acquisitions have not been as successful as it anticipated them to be. It acquired a stake in China based company Beingmate Baby & Child Food in 2015 (Fonterra, 2018b; Fonterra, 2018c). The acquisition has failed to live up to the expectations of Fonterra in terms of performance. All these factors have led to the company's revenues and profit margins being affected. This has resulted in poor financial performance from the company across the board since 2016. The company has already swung towards a loss, and if the company's financial decision making process is not improved, it will continue to record losses in the future (NZ Herald, 2018; Fonterra, 2018a).

6. NPV and IRR Analysis

Table 1: IRR and NPV Analysis

Company	NPV	IRR
Fonterra	-464,310	6%

Source: Fonterra (2018a)

As seen in the table above, Fonterra's Net Present Value (NPV) stands at -464,310. Further, the company's Internal Rate of Return (IRR) stands at 6%. These figures indicate that any investments made in the company would be highly risky. Since the NPV is negative, this is a clear indicator of the fact that the present value of costs incurred by Fonterra is higher than the expected future revenues. This is a worrying sign for the company, and it needs to reduce its costs in order to ensure that the returns for its investors are higher (Forisk Consulting, 2013).

Conclusion and Recommendations

From the above analysis, it is clearly evident that Fonterra is not heading in the right direction in terms of its financials. The company has witnessed a decline in its key financials as well as profitability. This is a worrying trend for the company. Therefore, it is critical that the company re-assesses its financial decision making process and starts making more prudent decisions. In addition to this, the company needs to control its operating expenses so that its operating margins are not affected. Also, the company needs to focus on boosting its sales numbers by investing more in capacity expansion. This will ensure that the company records higher revenues and improves its profitability in the long run as well. All of the above decisions will ensure that the company's financials get back on track and it maintains its leadership in the industry. Also, these decisions will help the company in improving its earnings per share, resulting in better returns for its shareholders. Finally, implementation of the above recommendations will help the company in rebuilding its financial health and improving its key financial ratios in the medium to long term (NZ Herald, 2018).

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Appendix

5 Year Balance Sheet

Fiscal year is August-July. All values NZD Millions.	2018	2017	2016	2015	2014
Cash & Short Term Investments	505	973	820	386	643
Cash Only	446	393	369	342	340
Short-Term Investments	59	580	451	44	303
Cash & Short Term Investments Growth	-48.10%	18.66%	112.44%	-39.97%	-
Cash & ST Investments / Total Assets	2.80%	5.45%	4.79%	2.11%	4.14%
Total Accounts Receivable	2,280	2,218	1,514	2,244	1,891
Accounts Receivables, Net	1,965	1,992	1,282	2,008	1,767
Accounts Receivables, Gross	1,987	2,015	1,302	2,023	1,775
Bad Debt/Doubtful Accounts	(22)	(23)	(20)	(15)	(8)
Other Receivables	315	226	232	236	124
Accounts Receivable Growth	2.80%	46.50%	-32.53%	18.67%	-
Accounts Receivable Turnover	8.96	8.67	11.36	8.40	11.78
Inventories	2,917	2,593	2,401	3,025	3,701
Finished Goods	2,206	1,913	1,754	2,325	3,082
Raw Materials	711	680	647	700	619
Other Current Assets	263	298	356	422	249
Prepaid Expenses	122	117	124	100	79
Miscellaneous Current Assets	141	181	232	322	170
Total Current Assets	5,965	6,082	5,091	6,077	6,484
Net Property, Plant & Equipment	7,098	6,710	6,514	6,490	5,091
Property, Plant & Equipment - Gross	12,360	11,586	11,109	10,905	8,998
Buildings	2,787	2,644	2,479	2,316	1,986
Land & Improvements	354	348	339	366	327
Machinery & Equipment	8,210	7,740	7,231	6,789	6,175
Construction in Progress	721	535	718	1,103	510
Other Property, Plant & Equipment	288	319	342	331	-
Accumulated Depreciation	5,262	4,876	4,595	4,415	3,907
Buildings	1,042	953	883	811	703
Machinery & Equipment	4,220	3,923	3,712	3,604	3,204
Total Investments and Advances	819	1,126	1,377	1,632	616
LT Investment - Affiliate Companies	615	887	960	1,185	388
Other Long-Term Investments	204	239	417	447	228
Intangible Assets	3,227	3,115	3,142	3,273	2,791
Net Goodwill	1,081	1,073	1,079	1,099	938
Net Other Intangibles	2,146	2,042	2,063	2,174	1,853

Other Assets	323	446	584	111	316
Tangible Other Assets	323	446	584	111	316
Total Assets	18,015	17,842	17,118	18,315	15,529
Assets - Total - Growth	0.97%	4.23%	-6.54%	17.94%	-
Asset Turnover	1.14	-	-	-	-
Return On Average Assets	-1.23%	-	-	-	-

Liabilities & Shareholders' Equity

All values NZD Millions.	2018	2017	2016	2015	2014
ST Debt & Current Portion LT Debt	992	1,123	967	1,720	1,555
Short Term Debt	161	11	967	512	485
Current Portion of Long Term Debt	831	1,112	-	1,208	1,070
Accounts Payable	3,256	3,013	2,359	1,728	3,106
Accounts Payable Growth	8.07%	27.72%	36.52%	-44.37%	-
Income Tax Payable	35	34	18	39	18
Other Current Liabilities	850	561	654	1,544	454
Accrued Payroll	276	276	302	287	220
Miscellaneous Current Liabilities	574	285	352	1,257	234
Total Current Liabilities	5,133	4,731	3,998	5,031	5,133
Long-Term Debt	5,907	5,151	5,397	5,879	3,364
Long-Term Debt excl. Capitalized Leases	5,772	5,151	5,397	5,879	3,193
Non-Convertible Debt	5,772	5,151	5,397	5,879	3,193
Capitalized Lease Obligations	135	-	-	-	171
Provision for Risks & Charges	130	148	152	186	65
Deferred Taxes	(578)	(354)	(366)	(623)	(226)
Deferred Taxes - Credit	5	9	44	109	5
Deferred Taxes - Debit	583	363	410	732	231
Other Liabilities	491	555	580	451	428
Other Liabilities (excl. Deferred Income)	491	555	580	451	428
Total Liabilities	11,666	10,594	10,171	11,656	8,995
Total Liabilities / Total Assets	64.76%	59.38%	59.42%	63.64%	57.92%
Common Equity (Total)	6,219	7,140	6,859	6,473	6,492
Common Stock Par/Carry Value	5,887	5,858	5,833	5,814	5,807
Retained Earnings	934	1,637	1,384	1,289	1,059
Cumulative Translation Adjustment/Unrealized For. Exch. Gain	(364)	(552)	(428)	(110)	(455)
Unrealized Gain/Loss Marketable Securities	-	-	-	-	(1)
Other Appropriated Reserves	(267)	192	64	(537)	82
Unappropriated Reserves	29	5	6	17	-
Common Equity / Total Assets	34.52%	40.02%	40.07%	35.34%	41.81%
Total Shareholders' Equity	6,219	7,140	6,859	6,473	6,492
Total Shareholders' Equity / Total Assets	34.52%	40.02%	40.07%	35.34%	41.81%
Accumulated Minority Interest	130	108	88	186	42
Total Equity	6,349	7,248	6,947	6,659	6,534
Liabilities & Shareholders' Equity	18,015	17,842	17,118	18,315	15,529

5 Year Income Statement

Fiscal year is August-July. All values NZD Millions.	2018	2017	2016	2015	2014
Sales/Revenue	20,438	19,232	17,199	18,845	22,275
Sales Growth	6.27%	11.82%	-8.73%	-15.40%	-
Cost of Goods Sold (COGS) incl. D&A	17,374	16,059	13,672	15,625	19,813
COGS excluding D&A	16,835	15,533	13,102	15,064	19,275
Depreciation & Amortization Expense	539	526	570	561	538
Depreciation	444	435	465	453	437
Amortization of Intangibles	95	91	105	108	101
COGS Growth	8.19%	17.46%	-12.50%	-21.14%	-
Gross Income	3,064	3,173	3,527	3,220	2,462
Gross Income Growth	-3.44%	-10.04%	9.53%	30.79%	-
Gross Profit Margin	14.99%	-	-	-	-
SG&A Expense	2,096	2,001	2,132	2,234	1,854
Research & Development	95	81	88	83	87
Other SG&A	2,001	1,920	2,044	2,151	1,767
SGA Growth	4.75%	-6.14%	-4.57%	20.50%	-
Other Operating Expense	-	-	-	327	355

EBIT	968	1,172	1,395	659	253
Unusual Expense	740	(89)	83	284	44
Non Operating Income/Expense	23	(108)	(18)	389	177
Non-Operating Interest Income	14	10	18	8	13
Equity in Affiliates (Pretax)	-	-	-	-	73
Interest Expense	439	405	434	414	335
Interest Expense Growth	8.40%	-6.68%	4.83%	23.58%	-
Gross Interest Expense	447	415	453	430	335
Interest Capitalized	8	10	19	16	-
Pretax Income	(174)	758	878	358	137
Pretax Income Growth	-122.96%	-13.67%	145.25%	161.31%	-
Pretax Margin	-0.85%	-	-	-	-
Income Tax	42	20	98	(82)	(42)
Income Tax - Current Domestic	76	72	113	97	52
Income Tax - Deferred Domestic	(34)	(52)	(15)	(179)	(94)
Equity in Affiliates	20	7	54	66	-
Consolidated Net Income	(196)	745	834	506	179
Minority Interest Expense	25	11	24	40	22

Net Income	(221)	734	810	466	157
Net Income Growth	-130.11%	-9.38%	73.82%	196.82%	-
Net Margin	-1.08%	-	-	-	-
Net Income After Extraordinaries	(221)	734	810	466	157
Net Income Available to Common	(221)	734	810	466	157
EPS (Basic)	(0.14)	0.46	0.51	0.29	0.10
EPS (Basic) Growth	-130.43%	-9.80%	75.86%	190.00%	-
Basic Shares Outstanding	1,610	1,605	1,601	1,598	1,598
EPS (Diluted)	(0.14)	0.46	0.51	0.29	0.10
EPS (Diluted) Growth	-130.01%	-9.60%	73.56%	196.70%	-
Diluted Shares Outstanding	1,610	1,605	1,601	1,598	1,598
EBITDA	1,507	1,698	1,965	1,220	791
EBITDA Growth	-11.25%	-13.59%	61.07%	54.24%	-
EBITDA Margin	7.37%	-	-	-	-
EBIT	968	1,172	1,395	659	253

5 Year Cash Flow Statement

Operating Activities

Fiscal year is August-July. All values NZD Millions.	2018	2017	2016	2015	2014
Net Income before Extraordinaries	262	1,120	1,431	424	503
Net Income Growth	-76.61%	-21.73%	237.50%	-15.71%	-
Depreciation, Depletion & Amortization	539	526	570	561	538
Depreciation and Depletion	444	435	465	453	437
Amortization of Intangible Assets	95	91	105	108	101
Other Funds	140	(436)	(902)	(246)	(268)
Funds from Operations	941	1,210	1,099	739	773
Changes in Working Capital	179	(214)	1,771	(490)	275
Receivables	75	(634)	485	182	(111)
Inventories	(313)	(177)	597	809	(757)
Accounts Payable	375	645	731	(1,508)	1,171
Other Assets/Liabilities	42	(48)	(42)	27	(28)
Net Operating Cash Flow	1,120	996	2,870	249	1,048
Net Operating Cash Flow Growth	12.45%	-65.30%	1052.61%	-76.24%	-
Net Operating Cash Flow / Sales	5.48%	5.18%	16.69%	1.32%	4.70%

Investing Activities

All values NZD Millions.	2018	2017	2016	2015	2014
Capital Expenditures	(1,050)	(882)	(1,039)	(1,414)	(893)
Capital Expenditures (Fixed Assets)	(903)	(779)	(954)	(1,310)	(791)
Capital Expenditures (Other Assets)	(147)	(103)	(85)	(104)	(102)
Capital Expenditures Growth	-19.05%	15.11%	26.52%	-58.34%	-
Capital Expenditures / Sales	-5.14%	-4.59%	-6.04%	-7.50%	-4.01%
Net Assets from Acquisitions	-	-	-	(771)	(18)
Sale of Fixed Assets & Businesses	105	167	291	112	58
Purchase/Sale of Investments	(151)	(42)	(305)	-	(78)
Purchase of Investments	(151)	(42)	(383)	-	(78)
Sale/Maturity of Investments	-	-	78	-	-
Other Uses	(14)	-	(67)	(3)	(99)
Other Sources	162	51	26	36	21
Net Investing Cash Flow	(948)	(706)	(1,094)	(2,040)	(1,009)
Net Investing Cash Flow Growth	-34.28%	35.47%	46.37%	-102.18%	-
Net Investing Cash Flow / Sales	-4.64%	-3.67%	-6.36%	-10.83%	-4.53%

All values NZD Millions.	2018	2017	2016	2015	2014
Cash Dividends Paid - Total	(453)	(456)	(701)	(233)	(336)
Common Dividends	(453)	(456)	(701)	(233)	(336)
Issuance/Reduction of Debt, Net	257	206	(906)	2,027	323
Change in Long-Term Debt	-	-	(906)	2,027	323
Issuance of Long-Term Debt	-	-	4,909	7,470	4,241
Reduction in Long-Term Debt	-	-	(5,815)	(5,443)	(3,918)
Other Funds	(101)	8	(35)	(23)	(8)
Other Uses	(101)	(30)	(35)	(23)	(16)
Other Sources	-	38	-	-	8
Net Financing Cash Flow	(297)	(242)	(1,642)	1,771	(21)
Net Financing Cash Flow Growth	-22.73%	85.26%	-192.72%	8533.33%	-
Net Financing Cash Flow / Sales	-1.45%	-1.26%	-9.55%	9.40%	-0.09%
Exchange Rate Effect	28	(23)	(80)	4	(28)
Net Change in Cash	(97)	25	54	(16)	(10)
Free Cash Flow	217	217	1,916	(1,061)	257
Free Cash Flow Growth	0.00%	-88.67%	280.58%	-512.84%	-
Free Cash Flow Yield	-2.86%	-	-	-	-

Source: Wall Street Journal (2018)