

The Treasury

Landcorp Farming Ltd: Independent Review Information Release

December 2021

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- [34] 9(2)(g)(i) - to maintain the effective conduct of public affairs through the free and frank expression of opinions
- [37] 9(2)(i) - to enable the Crown to carry out commercial activities without disadvantage or prejudice
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Reference: T2020/3696 SE-2-8-1

Date: 7 December 2020

To: Minister of Finance (Hon Grant Robertson)
Associate Minister of Finance (Hon David Parker)
Minister for State Owned Enterprises (Hon Dr David Clark)

Deadline: 9 December 2020

Aide Memoire: Landcorp Farming Limited – Meeting with the Independent Reviewer

The Minister for State Owned Enterprises (the Minister) is scheduled to meet with Dr James Morrison, the Independent Reviewer of Landcorp Farming Limited's (Landcorp's) performance, at 10.30am on 9 December 2020. Treasury officials are available to attend the meeting.

This meeting is an opportunity for the Minister to:

- understand, from the reviewer, the nature and progress of the review,
- seek insights into Landcorp's performance, and
- register any specific issues or areas of focus the Minister would like addressed in the review (noting that the Terms of Reference, attached, have already been agreed by the Minister of Finance and previous Minister and Associate Minister for State-Owned Enterprises (SOE)).

This report provides background information and questions that the Minister may wish to ask Dr Morrison.

Landcorp's background

Landcorp, which trades as Pāmu, is an SOE with a primary role to operate a nationwide pastoral farming business. Landcorp currently has 117 farms across New Zealand supporting sheep, beef cattle, dairy cows, deer, avocado orchards and forestry.

Landcorp earns annual revenues of approximately \$230-250 million, with around 90% of it coming from livestock and milk. Landcorp has a total asset base of approximately \$1.9 billion and a commercial value of \$1.3 billion. This makes it one of the three largest SOEs (along with NZ Post and Transpower).

As an SOE, Landcorp's principal objective is to be a successful business, and to this end, to be as profitable and efficient as comparable businesses not owned by the Crown, a good employer, and to exhibit a sense of social responsibility by having regard to the interests of the community in which it operates and by endeavouring to accommodate or encourage these when able to do so.

Outside of its primary role, Landcorp has a number of strategic initiatives often referred to as 'off-farm ventures'. These include, but are not limited to:

- a Pāmu Foods (100% ownership) – a value-add post-farmgate food business (not a separate company);
- b Spring Sheep (50% ownership) – a sheep milk production and marketing initiative;
- c Melody Dairies (35% ownership) – a sheep milk drying facility at Waikato Innovation Park;
- d FarmlQ (26% ownership) – an IT provider specialising in an information platform for farm management; and
- e Focus Genetics (100% ownership) – genetics research and development.

Landcorp's performance

Landcorp is susceptible to commodity price fluctuations and is attempting to build resilience through diversifying its revenue streams

Due to the nature of its business, Landcorp is susceptible to volatile commodity prices which heavily impact on its earnings from year to year. This has led to a strategy of lifting on-farm profitability coupled with value generated from off-farm activities. This is intended to create a more sustainable and resilient business model.

Landcorp's financial and non-financial performance to date has not met its own expectations, with operating profits varying significantly (up to 30% in some cases). While there is a rationale supporting the strategy, we have concerns about the company's execution, [34]

Landcorp is also endeavouring to become a leader in farm systems and reducing its environmental impacts, described commonly as 'industry good activities'. However, it is unclear exactly what activities are being undertaken and the costs and the benefits of such activities. Such activities may also conflict with the legislative requirements of SOEs to be successful businesses and be as profitable and efficient as comparable businesses that are not owned by the Crown.

[34]

Landcorp traditionally has large capital expenditure plans (approximately \$40 million in FY21) which are higher than its net operating cash flows. Therefore it relies on asset sales [34] to fund cash flow deficits. [34]

Landcorp is also particularly exposed to changes in commodity prices given its corporate overhead structure (which privately owned farms usually do not have) and its off-farm ventures [25]

Off-farm ventures, which were intended to provide greater resilience to variable commodity prices, [25], [34]

[37]

¹ Earnings before interest, tax, depreciation, amortisation and revaluations.

This, coupled with average EBITDAR and Total Shareholder Returns of \$41.5 million and 2.5% respectively over the last 10 years (which is significantly lower than its cost of capital of 6.5% per annum), has given rise to concerns over the execution of Landcorp's current strategy [25], [34]

[34]

[34] with segmented reporting not provided - making it difficult to assess the performance of individual operations and initiatives. Since 2013, shareholding Ministers have sought a greater level of transparency from Landcorp (as you may have seen from past letters of expectation) which Ministers are still yet to see.

Independent review

Shareholding Ministers asked the Treasury to commission an independent review...

As a result of performance issues, [34]

previous shareholding Ministers asked the Treasury to commission an independent review to further understand Landcorp's performance.

Landcorp commissioned its own independent review

Landcorp also commissioned its own 'independent' review in July 2020 and a report from PricewaterhouseCoopers (PwC) was delivered to previous shareholding Ministers in August 2020. The Treasury was not aware of, nor involved in, the scoping or drafting of this review. [34]

It was the intention of shareholding Ministers for both themselves and officials to be involved in the scoping of any review.

The PwC report covered some of Landcorp's key challenges, such as Wairakei Estate², and is a high-level review and questions:

- a whether Landcorp's general strategy make sense; and
- b [37]

Whilst the PwC report contained useful information regarding some aspects of Landcorp's operations and highlights a number of key challenges, [34]

The review states "we [PwC] have not audited or reviewed any of the information provided to us by Landcorp, including its financial budgets or financial statements, and therefore make no representation as to the accuracy or reliability of that information, nor the analyses on which they are based." Therefore, we believe that the PwC review it does do not address Ministerial concerns around actual performance, and the fact that actual performance differs from Landcorp's own forecasts.

² Wairakei Estate is a long-term lease [25]

The PwC review did not address key concerns. At the request of shareholding Ministers, the Treasury engaged an independent reviewer

The PwC report did not address the underlying reasons for lower than anticipated performance. Shareholding Ministers asked the Treasury to commission an independent review, with a Terms of Reference to be developed in consultation with Landcorp and agreed by previous shareholding Ministers.

The Treasury, following a search process and consultation with previous shareholding Ministers, has contracted Dr Morrison to undertake this independent review. Dr Morrison has expertise in business performance and strategy, and has experience in agribusiness and primary industries, in particular the dairy sector.

Dr Morrison has also been involved in the development of the Strategy for Sustainable Dairy Farming 2013-2020 report and the New Zealand Onion and Potato industry strategy, as well as conducting performance reviews of dairy co-operatives and acting as a special advisor to the Government's Primary Production Select Committee. Dr Morrison has also recently completed the Quotable Value strategic review for shareholding Ministers, which resulted in significant improvements at Quotable Value .

A Terms of Reference has been developed and agreed by shareholding Ministers in consultation with Landcorp

This review is a first stage review, consisting of significant information-gathering to assist in building a common understanding of Landcorp's performance to date. In particular, it will provide clarity on the gap between anticipated and actual performance, and examine both financial and non-financial contributing aspects.

The review is also intended to provide clarity over all of Landcorp's current operations, which includes 'industry good' activities being undertaken, and the trade-offs associated with its current operations.

A copy of the agreed Terms of Reference is attached to this report for your information.

Review to date

Dr Morrison began work on 23 October. To date, his work has concentrated on interviews with Landcorp and the Treasury, as well as reviewing information provided by both parties, in particular analysing the causes of low total shareholder returns and underlying performance outcomes. Dr Morrison has also noted that financial forecasts historically have had a high level of optimism, however this has improved over time.

Dr Morrison has noted that he has had not yet received full financial information from Landcorp, including the segmentation required to understand the different parts of the business. Obtaining segmental financial information is an issue that Treasury and previous shareholding Ministers have raised with Landcorp for a number of years.

From discussions with Dr Morrison, the Treasury believes that he has a strong understanding of the objectives of this review and the intended outcomes, however, he is still in an information gathering phase. Dr Morrison is on track to deliver a draft findings report by 19 February 2021 and a final report by 12 March 2021.

Speaking points

This meeting is an opportunity for the Minister to understand, from the reviewer, the nature and progress of the review, insights into Landcorp's performance and to register any specific concerns or areas of focus the Minister would like addressed in the review (noting that the Terms of Reference (attached) have already been agreed).

You may wish ask Dr Morrison:

- a for an overview of any current, initial observations, hypothesis and/or concerns;
- b about Landcorp's response to the review and its engagement with him;
- c about the next steps for the review;
- d for details of any challenges in undertaking the role and if so, whether shareholding Ministers can assist to ensure the required information is ascertained;
- e any other questions you may have relating to Landcorp's performance and/or the review scope, and
- f Dr Morrison's experience with the Quotable Value review and any lessons learned from that review that might be relevant to Landcorp, or the SOE portfolio more generally

Contact:

Amanda Wilson, Analyst, Commercial Performance, [39]

Juston Anderson, Acting Manager, Commercial Performance, [39]

Appendix - Landcorp Farming Limited – Independent Review Terms of Reference

September 2020

Overview

Landcorp Farming Limited (Landcorp) is a State-owned enterprise (“SOE”) with a stated vision “to become a world leader in farming natural resources sustainability to produce premium, high margin food and fibre products.”

Landcorp's core role is operating a nationwide pastoral farming business comprising of dairy, sheep, beef and deer farms. Landcorp operates approximately 115 farming units totalling 336,342 hectares, has turnover of around \$250 million per annum on a net asset base of \$1.3 billion, and has three subsidiary companies:

- Landcorp Holdings Limited, which holds Landcorp property protected from sale under an agreement with the Crown;
- Landcorp Estates Limited which develops and sells premium land that is deemed to have a higher value in non-agricultural use; and
- Landcorp Pastoral Limited, which is Landcorp's investment vehicle in the Focus Genetics Limited Partnership and Spring Sheep venture.

In addition, Landcorp also has a number of off-farm investments:

- Pāmu Foods (100% ownership);
- Spring Sheep (50% ownership);
- Melody Dairies (35% ownership);
- FarmIQ (26% ownership); and
- Focus Genetics (100% ownership).

Landcorp's challenge is to achieve profitability and resilience in the context of being a corporate farmer with associated corporate costs not faced by a unitary farm operation. To achieve this, the strategic approach adopted in 2014 includes leveraging off its scale and building resilience through diversification of revenue streams, including through creating value in off-farm ventures. Landcorp defines its strategic imperatives as follows:

- Drive consistent operational excellence in all aspects of its pastoral farming business (environmental, profitability, people, animal welfare, innovation and technology);
- Create scale and financial materiality in value-add dairy businesses, and leverage these learnings and expertise into other food and fibre products;
- Expand forestry, fibre, cropping and horticulture business: grow ecosystem service net returns from carbon, biodiversity, wind and pollination, optimised to complement its livestock; and
- Maximise returns and value from its subsidiaries and joint ventures.

However, performance to date has not clearly demonstrated that the strategic approach is delivering as intended. [37]

³ Earnings before interest, tax, depreciation, amortisation and revaluations

[25] and operating profits have varied significantly from budget over the last eight years, up to 30% in some cases. Landcorp also traditionally has large capital expenditure plans (approximately \$40m higher than operating cash flows in FY21) and relies on asset sales to fund these cash flow deficits. This, coupled with average EBITDAR and Total Shareholder Returns of \$39.1m and 1.3% respectively over the last 10 years, has given rise to concerns over the execution of Landcorp's current strategy [25], [34]

This review is intended to provide a deeper understanding of the underlying factors contributing to Landcorp's performance outcomes. This, in turn, will provide a clearer picture of Landcorp's ability to deliver on its strategy and produce sustainable returns consistent with meeting its legislative objectives "to operate as a successful business and be as profitable and efficient as comparable businesses, not owned by the Crown."

Review Objectives and Scope

The Treasury wishes to engage a qualified consulting firm or individual(s) (the "Consultant") to undertake an independent assessment of Landcorp's recent performance to understand the underlying reasons for the gap between the company's forecast and actual performance.

This review is a first-stage review to provide a foundation level of understanding to shareholders on the performance of Landcorp, including matters that distinguish it from other farming operations, and provide direction for any subsequent, more targeted, reviews, if required.

- At a high level, the review should incorporate the following matters:
 - a review and verification of Landcorp's budgets and projected results and actual performance⁴ from both corporate and strategic initiatives⁵;
 - an analysis of the factors that contributed to variances between projected and actual performance, at both corporate and strategic initiative level. This analysis should consider:
 - the performance of Landcorp's core farming business;
 - assumptions used in business cases and performance projections (both core and in strategic initiatives);
 - challenges and issues relating to markets, including market entry and market development;
 - what allowance, if any, should be made for the testing and measurement of alternative farm systems; and
 - any other underlying factor(s), which have had a material, impact upon the ability of Landcorp to meet performance expectations;
 - the risks to the strategy delivering in-line with projected performance, in light of the above. This includes an assessment of current strategic initiatives, their risks and future viability;

4 not limited to financial performance

5 strategic initiatives include off-farm ventures as well as on-farm innovation.

- consideration to the operating environment at the time of any decisions or forecasts being made and clear analysis on the distinction between the factors inside and outside of Landcorp's control; and
- recommendations for any matters requiring further review.

It is intended that this exercise will, at a minimum, provide clarity over the activities that Landcorp is undertaking and consider associated trade-offs contemplated by section 4 of the State-Owned Enterprises Act 1986. This includes considering, amongst other things, additional costs and benefits, if any, associated with Landcorp's current approach to environmental and safety standards and prototyping non-standard modes of production.

The Treasury is flexible on process, design and format. For example, undertaking meetings and workshops with Landcorp staff and management (individually and as a group) would help the Consultant to receive information and insights on the business/markets as well as gain their support and buy-in with this project.

Out of scope

- Any reassessment of the vision, purpose, objectives, mandate and strategy of Landcorp; and
- Statement of Corporate Intent.

Project Approach

The Consultant's approach will be evidence-based, highly consultative, engaging and hands-on. This will mean that the Consultant will seek input from relevant people within Landcorp and the Treasury, for both information and their perspective on the opportunities and challenges, and meet with shareholding Ministers at the commencement of the review.

A logical, staged approach to the work is contemplated, with each discrete phase defined by specific deliverables. It is important that source information is verified, where possible, as part of any analysis undertaken.

It is expected that any initial findings or draft reports be provided to both the Treasury and Landcorp so that both parties have an opportunity to provide any additional context, if required.

The timeframe for this project is to be determined following conversations with potential consultants.