The Treasury

Landcorp Farming Ltd: Independent Review Information Release

December 2021

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[33] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials

[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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[40] Not in scope

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Reference: T2021/481 SE-2-8-2

Date: 15 March 2021

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

Copy to: Associate Minister of Finance (Hon David Parker)

Deadline: None

Landcorp Farming Limited – Independent Review

On 26 February 2021, Dr James Morrison provided you with his draft report into the performance of Landcorp Farming Limited (Landcorp).

This Aide Memoire is intended to provide a high-level overview of the draft report's key findings and some commentary on potential implications. Full advice and recommendations on next steps will be provided following receipt of the final report due 19 March 2021.

As this review sits outside of Associate Minister's day-to-day delegations, the shareholding Ministers (Minister of Finance and Minister for State Owned Enterprises) will be the responsible Ministers for any resulting decisions. We intend to copy the Associate Minister of Finance (Minister Parker) into any discussions to ensure he is kept apprised. Landcorp's 2021/22 Letter of Expectations (LOE) has been delayed due to this review. Any decisions relating to the LOE will be the responsibility of the Associate Minister of Finance and Minister for State Owned Enterprises, as per the current delegations.

There are five key themes emerging from this draft report:

1 Performance gap – EBITDAR[1] projections have largely not been met and variances are not fully explained by on-farm performance or commodity prices.

2 On-farm performance – in general, this has been well performing with significant improvements in health and safety, environmental practices and on-farm diversification.

3 Off-farm ventures – [25]
[25], [34]

4 Corporate overheads – [37] , these have been assessed as high and are in part due to choosing a complex business structure, which the review questions.

[1] Earnings before interest, tax, depreciations, amortisation and revaluations

5 Performance management – weaknesses in financial systems and constantly changing performance targets [34]

Further detail on the substance of the draft report can be found in Appendix 1.

Potential implications

The report highlights a number of issues across the business area assessments such as capability concerns, financial system weaknesses, off-farm forecasting, governance and a lack of transparency.

[25], [34]

Corporate overheads are also not being applied to on-farm operations, distorting key performance metrics. If corporate overheads were allocated to on-farm ventures, it is uncertain whether Landcorp would be above the sector benchmarks for its farms.

[25], [34]

[37]

[34]

The Review notes that Landcorp is undertaking a number of value-add activities on-farm which is having a positive impact and demonstrates that it does not need to go off-farm to achieve the outcomes sought by its strategy. The different capability required to deliver a number of the off-farm ventures, coupled with high corporate overhead costs [25], [34]

The question of whether Landcorp's current strategy is appropriate was out of scope of this review, [25], [34]

Landcorp's Statement of Corporate Intent (SCI) targets change year on year and moved from quantifiable targets (12% TSR) to individual targets which change year-on-year depending on the budget. [25], [34]

[25], [34]

At a minimum further improved transparency is required, which has been a key expectation of shareholding Ministers for a number of years.

Next Steps

Dr Morrison has received comments from both Landcorp and the Treasury on the draft report. He is currently considering that feedback with the final report due on 19 March 2021. We understand that that Dr Morrison has a number of 'softer' observations from the review process, such as culture and behaviours, which weren't included in the draft report, but will be included in the final report.

Following the release of the final report, we will work with Landcorp to understand the implications and expect the Board to prepare a response to shareholding Ministers on the recommendations and how it intends to address them. [34]

The Treasury will also provide further analysis and options to address any concerns and plans to seek a view from shareholding Ministers on those options, by the end of March 2021. We expect that there will be a range of options to consider, from expecting Landcorp to make improvements at the margin (transparency, financial systems review, long-term performance management etc.) [25], [34]

Following agreement on next steps, the Treasury will then prepare a draft LOE for you to consider in April 2021. This will delay the delivery of Landcorp's final SCI, however, shareholding Ministers have the ability to extend the deadline for the delivery of a final SCI under section 14(4) of the State-Owned Enterprises Act 1986.

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APPENDIX 1: SUMMARY OF DRAFT REPORT

Background

Landcorp, which trades as Pāmu, is an SOE which was established in 1987 to commercially farm land held by the former Department of Lands and Survey that was not appropriate for the conservation or forestry estate and had potential for farming.

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.

Landcorp also 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 FarmIQ (26% ownership) – an IT provider specialising in an information platform for farm management; and

e Focus Genetics (100% ownership) – genetics research and development.

As a result of a number of performance concerns, previous shareholding Ministers asked the Treasury to commission an independent review to further understand Landcorp's performance and agreed a Terms of Reference in late 2020.

At a high level, the review was intended to analyse the variance between actual and anticipated performance since the adoption of its current strategy in FY13 and any factors that may have contributed to this including the risks to the strategy delivering in-line with projected performance. This also included an assessment of each of the off-farm ventures, however, the assessment of Landcorp's vision, purpose, objectives and strategy were outside of the scope of this review.

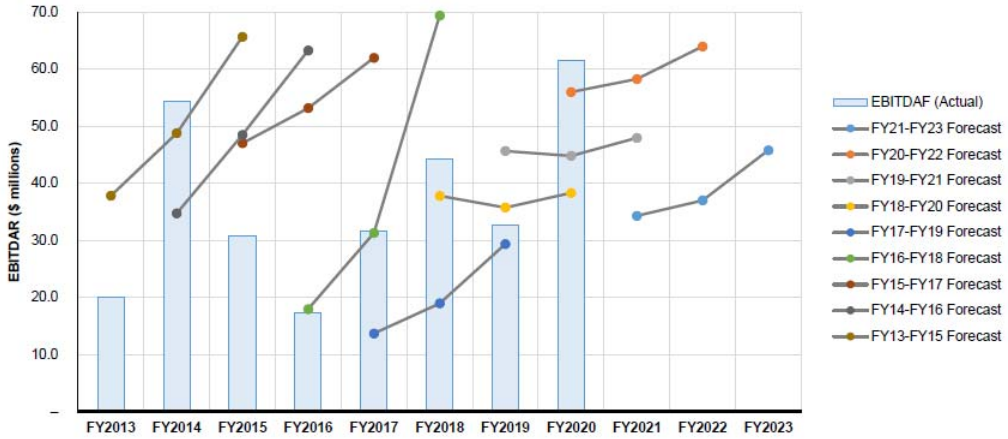
This review is a first-stage review to provide a foundation level of understanding to shareholders on the performance of Landcorp, including matters that distinguish it from other farming operations, and provide direction for any subsequent, more targeted, reviews, if required.

Performance Gap

At a group level, only five of the fifteen EBITDAR forecasts made between FY16-FY20 have been within 10% of actual EBITDAR. This gap is shown in Figure 1 below. The hypothesis that this gap between forecast and actual performance was attributable to the on-farm business and the volatility of commodity prices has not been proven.
In general, Landcorp has been fairly accurate in its commodity price forecasting. There have been variances between operating revenue and expenditure projections on-farm.

In some years, these account for almost all of the performance gap, however, more commonly, revenue and expenditure moved in corresponding directions meaning the significant deviations from budget could not be explained by on-farm ventures. It is, therefore, noted that off-farm activities are a significant contributor to the performance gap [25]

Figure 1: Actual v Budget EBITDAR performance:



In addition, Landcorp's average Total Shareholder Return (TSR) of the last five years is negative 0.8% which is well short of the 12% target it set in FY16 and now below the long-run average for farming (1.9%).

Through the assessment of this variance, the review found that Landcorp's financial systems restate all prior forecasts to reflect current hierarchies e.g. changes in accounting lease standards update the current years financial information to reflect these changes, and overwrite previous years financial information to apply this change without keeping a copy of the actual financial performance in that year. In addition, Landcorp holds no reliable record exists of divisional forecasts prior to FY17 and even the forecasts made in FY17 and FY18 had to be recreated and restated. The review has noted that this will create difficulties for Landcorp in being able to produce this level of transparency year-on-year.

On-farm performance

There have been some significant improvements in Landcorp's on-farm performance, environmental practices, health and safety practices and diversifications of revenue.

The review currently states that Landcorp has made significant improvements in health and safety in line with sector improvements. We understand that Dr Morrison is currently revising this commentary, due to additional information being provided, and the final report will show that not only has its lost time injury statistics reduced by more than 13% per annum, but it is performing above the industry in this area.

Landcorp's dairy division has successfully sought higher premium prices and diversification of revenue through its proactive movement to organic farms shifting a proportion of its supply from Fonterra to Synlait and Miraka, creating approximately $4.8 million of additional revenue per season once the current organic conversions are completed.

The review finds that Landcorp is estimated to be below the national average for gross agriculture emission intensity and its GHG emissions on farm (net per hectare) have decreased by an average of 16.3% per annum.

These initiatives and on-farm diversification (e.g. the shift to organic farms, lower intensity and introduction of forestry) are value-add and the review notes that it is not clear that Landcorp needs to be engaged in off-farm value add to meet its strategic intentions.

The review has also considered Landcorp's 'industry good' activities and found that it does participate in these activities, however, not to the extent expressed in the July 2020 Landcorp commissioned PricewaterhouseCoopers (PwC) report or above expectations. Of the 32 initiatives in the PwC report, this review finds only 7 able to be readily validated as industry good. It is also noted that, in general, Landcorp does not have a structured approach to 'industry good', nor monitoring and reporting structures to measure the benefits or attributions to Landcorp. The review notes that the most efficient way for Landcorp to meaningfully contribute to industry good activities it to create more partnerships and collaborate with industry good organisations.

This review did not include a deep dive into on-farm operations and relied on the information provided to support its analysis.

Off-farm performance

[25]

[25], [34]

[25], [34]

Pāmu Foods is highlighted in the draft report as an area of high concern. The original business case showed that this venture was entered into due to some 'threats' identified to the existing Landcorp business model which included:

- exposure to commodity volatility;
- inability to pay a consistent dividend;
- low cash returns from assets;
- "continual scrutiny from the government as a consequence of the above" and;
- "equal frustration in Landcorp due to constraints on investment with a risk adverse and capital constrained shareholder."

Pāmu Foods was established in FY18 [37]

Landcorp conducted an internal review into Pāmu Foods in 2019, which saw a pivot from a B2C[3] model to a B2B[4] model. [34]

[37]

[34]

The Melody dryer was largely approved to support Spring Sheep and Pāmu Foods, however, Pāmu Foods has underutilised the dryer and its operation appears to be more aligned to Spring Sheep requirements. [25]

The review also notes that there are other mechanisms that exist to channel public funds into food processing infrastructure. For example, Food Innovation Waikato was established on public funding and as a result constructed the first milk dryer at the Waikato Innovation Park.

Focus Genetics and FarmIQ complement Landcorp's core business and also play an industry good role. [25]

Corporate Overheads

Corporate overheads [37] but are not allocated to on-farm operations, therefore, true costs are understated which distorts performance. The review has benchmarked Landcorp's corporate overheads and finds that they are high in comparison, largely due to the complex business structure that Landcorp has chosen. The review also notes that being transparent about the allocations of corporate overheads will provide an incentive for them to be reduced.

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[37]

[37]

3 Business to Consumer

4 Business to Business

A Landcorp commissioned review in 2019 did not identify material savings, however, noted that the picture is incomplete without a deeper dive into certain parts of the business. This next step does not appear to have occurred.

Landcorp is now expanding its corporate office further with a new General Manager Sustainability and Farming systems being added along with 11 staff.